



# **An Assessment of Kentucky's Fiscal Condition**

Prepared by the  
Administration of  
Governor Paul E. Patton  
November 2002

## **EXECUTIVE SUMMARY**

Kentucky is at a critical crossroads. Sustained failure of the General Fund over a three-year period to generate revenue adequate to fund the ongoing commitments of Kentucky State Government has led to an unprecedented fiscal crisis in the Commonwealth which forces our society to either substantially raise revenues or make draconian cuts to existing programs. We face these choices at a time when the state is making progress in a number of key areas, most notably education reform.

During fiscal years 2001, 2002, and 2003, actual revenue was, or will be, much less than the budgeted expenditures. The administration has addressed this problem by making the cuts in budgeted expenditures which could be made without severely impacting service delivery to Kentuckians and using non-recurring funds to finance essential services. The cuts have so far totaled \$463.8 million during the three-year period and the use of non-recurring funds to date has totaled \$680 million. Our people have not yet felt real pain as a result of this sustained slowdown in state revenue growth, but we no longer have the options we have had to cut funding without impacting service delivery. We are out of non-recurring funds, and easy cuts in the budget.

This report documents, in detail, how the administration viewed the state finances in preparation for the FY 2001-2002 biennial budget enacted in the 2000 session of the General Assembly and the FY 2003-2004 biennial budget proposed for the 2002 session.

The report also details the state's current fiscal situation based on the revised official forecast of the Consensus Forecasting Group released November 15, 2002.

The report graphically illustrates in Graph 3, on Page 5A, that our revenue stream has developed a structural deficiency which cannot be overcome in the foreseeable future without major program cuts or increased revenue. Table 1, on Page 5B, documents that the budget shortfall will be 2.1 percent in FY 03 and 5.2 percent in FY 04. Graph 8, on Page 9A, illustrates the erratic nature of our revenue generating system in recent years and again dramatically demonstrates that this crisis is unlike other budget shortfalls of the past.

The report emphasizes that the needed revenue is not to begin new programs or expand the scope of existing programs but rather is what must be available to pay for the promises we have already made to our citizens. We have had budget shortfalls in the past, but never before have we had less revenue for providing services in one year than we collected in the previous year.

The bottom line is that, absent increased revenue, additional cuts in the FY 03 spending plan of \$144 million will have to be made and cuts of \$365 million will

have to be made in the FY 04 budget proposal the Governor made to the 2002 special session. The cuts in FY 03 will hurt. The cuts in FY 04 will stop the progress in Kentucky that has been made during the past twelve years, especially in education. In addition to the cuts which will have to be made to accommodate the budget shortfall, there will be no money in FY 04 to address the \$135 million needed to fund the Medicaid program or the \$11 million needed to house the increase in prison population caused primarily by the poor economy.

The report identifies some of the key aspects of the current financial situation in Kentucky. These include:

- Kentucky's tax code is outdated and produces revenue erratically and inadequately. Comprehensive tax reform is needed to keep the situation from getting worse.
- The tax increases adopted to pay for KERA-related initiatives will fall \$263 million short of the amount needed to fund KERA-related programs in FY 04.
- Corporate support for education through state revenues has not been as strong as was anticipated when the KERA tax increases were enacted. In fact, corporate support for Kentucky State Government has declined. The percent of General Fund revenue received from the corporate income tax and the corporate license tax fell from 10.0 percent in 1990 to 5.0 percent in 2002. If it were still 10.0 percent in FY 04 the increase would be \$350 million.
- During the Patton Administration 26 different tax cuts totaling \$2.24 billion dollars cumulatively and another \$485 million in FY 04 will have been implemented. These tax cuts have been as the result of legislative action, judicial action, and executive action.
- The percent of personal income of Kentuckians devoted to state and local governments has declined from 11.9 percent in FY 95 to 11.1 percent in FY 99 (the last fiscal year for which data is available). This is a 6.7 percent decline. This is the largest percent decline of all our neighboring states. If it had remained at 11.9 percent for FY 04 our General Fund would take in \$485 million more money in FY 02.
- The fiscal problems of the state, which have much of their origins in 1990, have been masked by the strong revenue growth from FY 95 through FY 00.
- Previous budget crises faced by Governor Brown and Governor Jones occurred while revenue was increasing and were therefore a crisis of over-commitment, not declining revenue. The current budget crisis is a crisis of deficit revenue, not new commitments because the budget proposed by the Governor in the 2002 session has no new commitments and is a true continuation budget.
- Because the administration has already cut Medicaid and postsecondary education 2 percent and all the rest of government

except K-12 education 5 percent, any further cuts will directly affect service delivery.

- Federal tax actions and the impending Tennessee lottery will further erode state revenues.
- Summaries of several studies of Kentucky's tax burden indicate that Kentucky has relatively high taxes on individual and relatively low taxes on corporations.
- The impact of across-the-board cuts in state programs would be dramatic. Exempting only our debt service obligations, across-the-board cuts in FY 04 would be 5.2 percent. If Elementary and Secondary Education were also exempted, the rest of the government would suffer 9.1 percent cuts. If K-12 education and the Department of Corrections were exempted, the cuts to rest of government would be 9.9 percent. If the Medicaid program were also exempted, the cuts would be 12.4 percent for the rest of government. And, if we exempted K-12, Corrections, Medicaid, and Postsecondary Education, the remaining areas of state government would suffer cuts of 20.5 percent.

This report calls for bipartisan dialogue to address the options of reducing important services or increasing revenue to pay for commitments we have already made. In recent years, Kentucky has made dramatic progress in the key areas of public policy that can insure a brighter economic future for our people. In every arena of education . . . Early Childhood, Elementary and Secondary, Postsecondary, and Adult Education, Kentucky's efforts are seen as national models.

We are making the investments necessary to compete in a changing economy and our efforts are beginning to show results. What effect will major cuts have on our progress in these areas? As the Commonwealth now faces the critical decisions that are forced upon us by this revenue crisis, will we turn back and lose the momentum of our recent progress? As elected officials, we have a responsibility to make the difficult choices that will determine the future prosperity of the citizens we serve.

## Introduction

Kentucky faces an unprecedented fiscal problem, a fiscal crisis different from those we have faced in the past. We are trying to deal with the first actual decline in state revenue in at least 50 years. We are not alone. Almost every other state is in the same or worse condition. Ray Scheppach, Executive Director of the National Governors Association has stated, "This is the worst fiscal crisis to hit the states since World War II."

Stated simply; our current revenue stream is about 5.2 percent below the cost of sustaining current commitments. This shortfall is a structural problem with only two possible solutions; permanent reduction of state services, or a significant increase in revenues. This is not a crisis of not being able to expand government to meet new and real needs of a growing society in an increasingly complex world. It is a crisis of trying to keep current commitments. There are new but no less pressing needs of today like the cost of prescription drugs or the cost of addressing the growing problem of drug abuse but those problems will have to wait for a solution. Our first concern must be current commitments like education. If the budget is cut, education will be the prime loser because it constitutes 58.4 percent of the General Fund budget.

This paper is prepared to give the serious student of the problem a detailed explanation, from the Patton Administration perspective, of what the situation is, some of the reasons for the crisis, and the consequences of a 5.2 percent reduction in current spending levels.

This report is primarily focused on the General Fund (GF) during the period from July 1, 1995, (the beginning of FY 96) to June 31, 2004 (the end of FY 04). This time frame generally covers the Patton Administration. The FY 96 budget was enacted during the Jones Administration and expended during the last six months of the Jones Administration and the first six months of the Patton Administration. The FY 04 budget will extend into the first six months of the next administration.

This report is an attempt to analyze recurring revenue and recurring expenses so in some data, non-recurring revenue and expenses have been deducted.

## Background

During the mid and late '90s, a strong economy allowed Kentucky State Government revenue to grow substantially relative to inflation. This unsustainable growth permitted several tax cuts to be enacted and allowed the Commonwealth to increase commitments to on-going programs, make one-time investments in infrastructure, and accumulate a record-high Budget Reserve Trust Fund (BRTF), \$278.8 million. We also had about \$400 million of surplus money in other funds.

We have had budget crises before. Governor Brown faced a severe budget crisis in FYs 81 and 82. But revenue in FY 81 increased 6.3 percent and in FY 82 it increased 10.7 percent (see Graph 4, Page 6A). Governor Jones faced a budget crisis in FYs 93 and 94. But revenue increased in FY 93 by 3.5 percent and in FY 94 by 3.0 percent. These governors faced not so much a revenue problem but rather an over-commitment problem.

### The Patton Administration Budgets

When Governor Patton assumed office and prepared his first budget proposal for the 1996 session of the General Assembly, the fiscal situation looked bleak. Revenue growth for the fiscal year then current, FY 96, was forecasted to be 2.2 percent. For FY 97 growth was forecasted to be 3.9 percent and for FY 98 growth was forecasted to be 4.5 percent. Governor Patton proposed a continuation budget, promising to revisit the budget in special session if revenue improved. It did.

Actual revenue growth for FY 96 was 3.5 percent. For FY 97 it was 6.1 percent and for FY 98 it was 6.1 percent. This allowed increased appropriations to postsecondary education and juvenile justice in the April 1997 special session and very good budgets for FYs 99 and 00 to be adopted in the 1998 session. Revenue growth for FY 99 was forecasted to be 7.7 percent above the revenue forecast upon which the FY 98 budget was based and revenue growth for FY 2000 was forecasted to be 4.7 percent. These estimates turned out to be very accurate.

This prosperity continued into the 2000 session of the General Assembly because revenue was forecasted to grow 4.9 percent in FY 01 and 4.9 percent in FY 02.

A fundamental principle of the Patton Administration has been to look to the future, not just the next two years. To guard against creating problems for the future, the Office of State Budget Director projected revenues and expenditures for FY 03 and FY 04.

Graph 1 portrays the financial situation of the state as the administration viewed it in December 1999 as it was preparing a biennial budget proposal for the 2000 session of the General Assembly. There was every reason to believe that the prosperity of the 90's would continue for two more years.

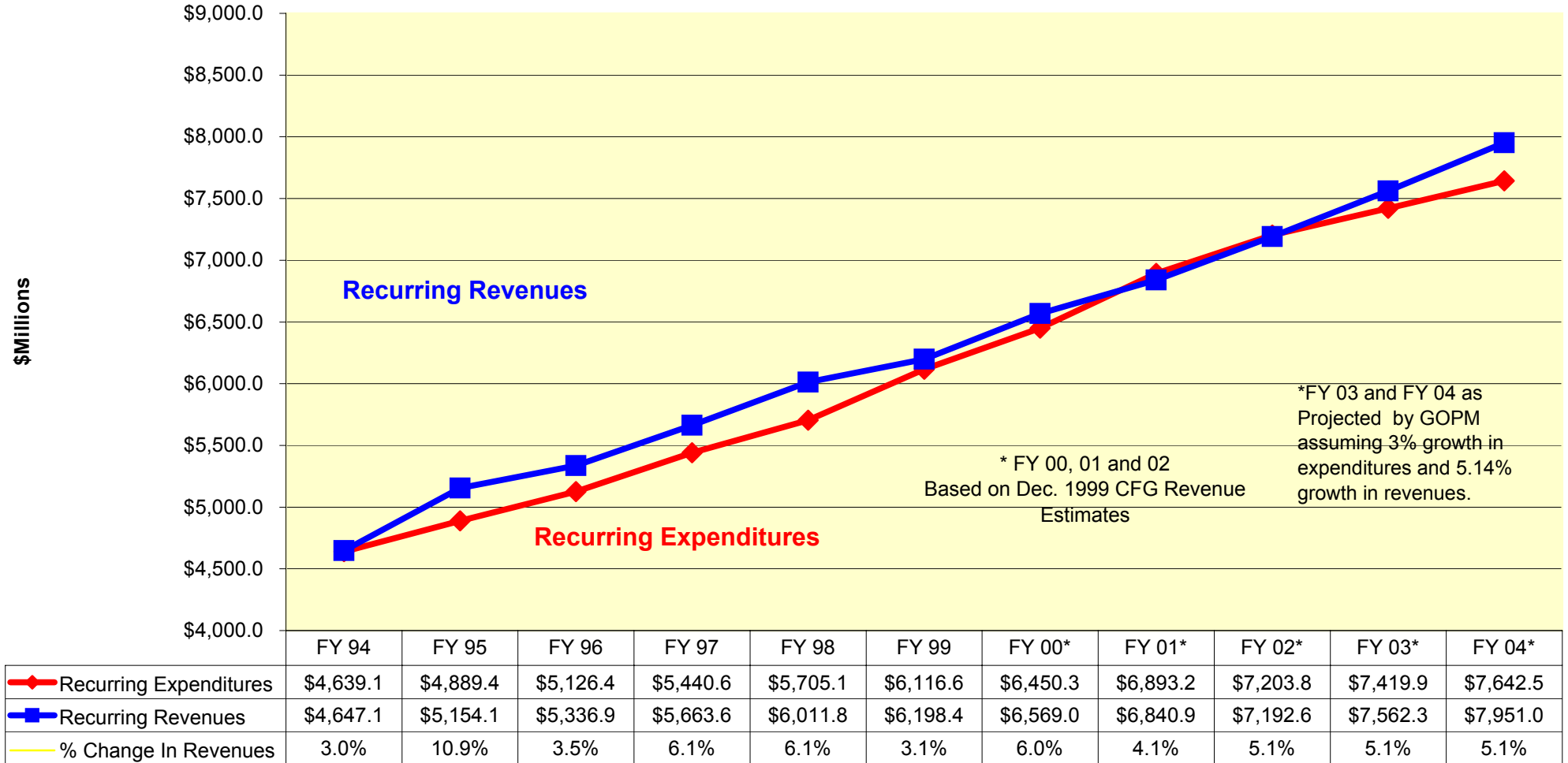
These appeared to be conservative forecasts. For FY 00 it was conservative. Actual revenue was \$47.2 million more than forecasted just six months before the end of the fiscal year. That was not the case for FY 01 when revenue fell \$159.4 million short of the forecast and certainly not the case for FY 02 when revenue fell \$617.6 million short.

# GRAPH 1

## Recurring General Fund Revenues and Recurring Expenditures (FY 94 - FY 04)

As Estimated In December of 1999

(Actual amounts from FY 94 - FY 99. Estimates from  
FY 00 - FY 02. Projections for FY 03 & FY 04)



## The Problem Begins

By late 2000 a slow-down in state revenue was becoming apparent. FY 01 revenue growth slowed dramatically to 2.7 percent and FY 02 revenue was obviously not going to reach the estimate upon which the budget was based. The administration cut spending and used non-recurring resources such as fund transfers<sup>1</sup> and the BRTF to get through FY 01 and FY 02 without making cuts which directly affected service delivery.

In FY 01 the budget shortfall<sup>2</sup> was \$185.4 million, 2.68 percent of the originally estimated revenue. This shortfall was addressed by cutting budgeted expenditures by \$114.0 million and using \$38.8 million from the BRTF and \$32.7 million in fund transfers.

FY 02 produced a major budget shortfall of \$687.1 million, 9.41 percent of the originally estimated revenue. This shortfall was addressed by using the remaining \$240.0 million in the BRTF, \$97.3 million in non-recurring fund transfers, and cutting budgeted expenditures \$349.8 million. These cuts included two percent cuts in Medicaid and postsecondary education and, in general, a 5 percent cut in the rest of government except K-12 education, which was not cut.

## The Current Biennium

In preparation for the 2002 session of the General Assembly, the administration made a concerted effort in December of 2001 to analyze the state's short-term and long-term financial situation and concluded that, by funding short-term revenue shortfalls with non-recurring resources, the state could maintain what is essentially a continuation budget through the FY 03-04 biennium and turn the state over to the next administration in December of 2003 in a position to be able to resume increasing expenditures as programs need to grow to serve a growing economy.

At that time, it was known that FY 01 had resulted in a structural deficit (a year in which the recurring expenses of on-going programs exceed revenue) and it was projected that FY 02, even after major cuts, would likewise result in a major structural deficit. Projections through FY 04 indicated that with a continuation budget and the continued use of non-recurring funds the structural deficit could be overcome by FY 05. Reversing its previous strong stand against structurally unbalanced budgets, the administration reluctantly made a considered judgment to

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<sup>1</sup>A fund transfer is a transfer of money from other funds normally devoted to expenditures for special services. In general, funds transferred are funds in excess of the amount needed to carry on the essential functions of the specified service.

<sup>2</sup>Budget shortfall refers to the difference between budgeted expenses and total resources available. Revenue shortfall refers to the difference between estimated revenue and actual revenue. The budget shortfall for FYs 01 and 02 is different from the revenue shortfall for these years because expenses for things like necessary government expense were different than budgeted.

propose a structurally unbalanced continuation budget using non-recurring funds to sustain existing commitments because the alternative would have been major cuts in education and other services which it appeared at that time could be avoided.

For simplicity's sake, this report refers to FY 03 and FY 04 "budgets" but it is important to acknowledge that the Commonwealth has no legislatively enacted budget for these two fiscal years. The term "budget" when referring to the current biennium is referring to the Governor's Spending Plan for FY 03 and the Governor's proposed budget for FY 04 which was adopted in the 2002 Special Session without change by the House and with practically no change by the Senate. This proposal funded every item in the budget passed by the House in the regular session and every item in the budget passed by the Senate in the regular session. The administration believes it is the best document it can use to reflect legislative intent and is the budget Kentucky must fund if we are to avoid cuts in services that will adversely affect Kentuckians.

The budget the administration recommended for FY 03 and FY 04 funded a 2.7 percent raise for state employees and the estimated increase of 11 percent for the cost of health insurance for state government employees, school district employees and other covered groups. Generally, there was no increase for other current operating costs. The administration's proposal funded a 2.7 percent wage increase for school personnel in FY 04 but mandated that local school boards absorb this cost in FY 03. Cabinets were instructed to absorb inflationary and other cost increases within the budgeted funds which, with the two exceptions mentioned before, were virtually the same for FY 03 and FY 04 as they were in FY 02 which had, in general, been cut 5 percent below what the General Assembly had authorized in the 2000 session. Graph 2 portrays the financial situation of the state as the administration viewed it in December 2001 as it prepared to propose a budget for the 2002 session of the General Assembly.

After the administration's proposal was introduced, the legislature increased total appropriations in excess of the expenditures recommended by the administration by \$67.3 million in FY 03 and \$81.4 million in FY 04 to fund the 2.7 percent raise for school personnel in FY 03. Additional fund transfers and other sources were identified to fund the increases. While these increases were more than justified, these additional expenditures have made the current budget the tightest the Patton Administration has administered. There is little slack to accommodate reduced revenue without directly affecting service delivery.

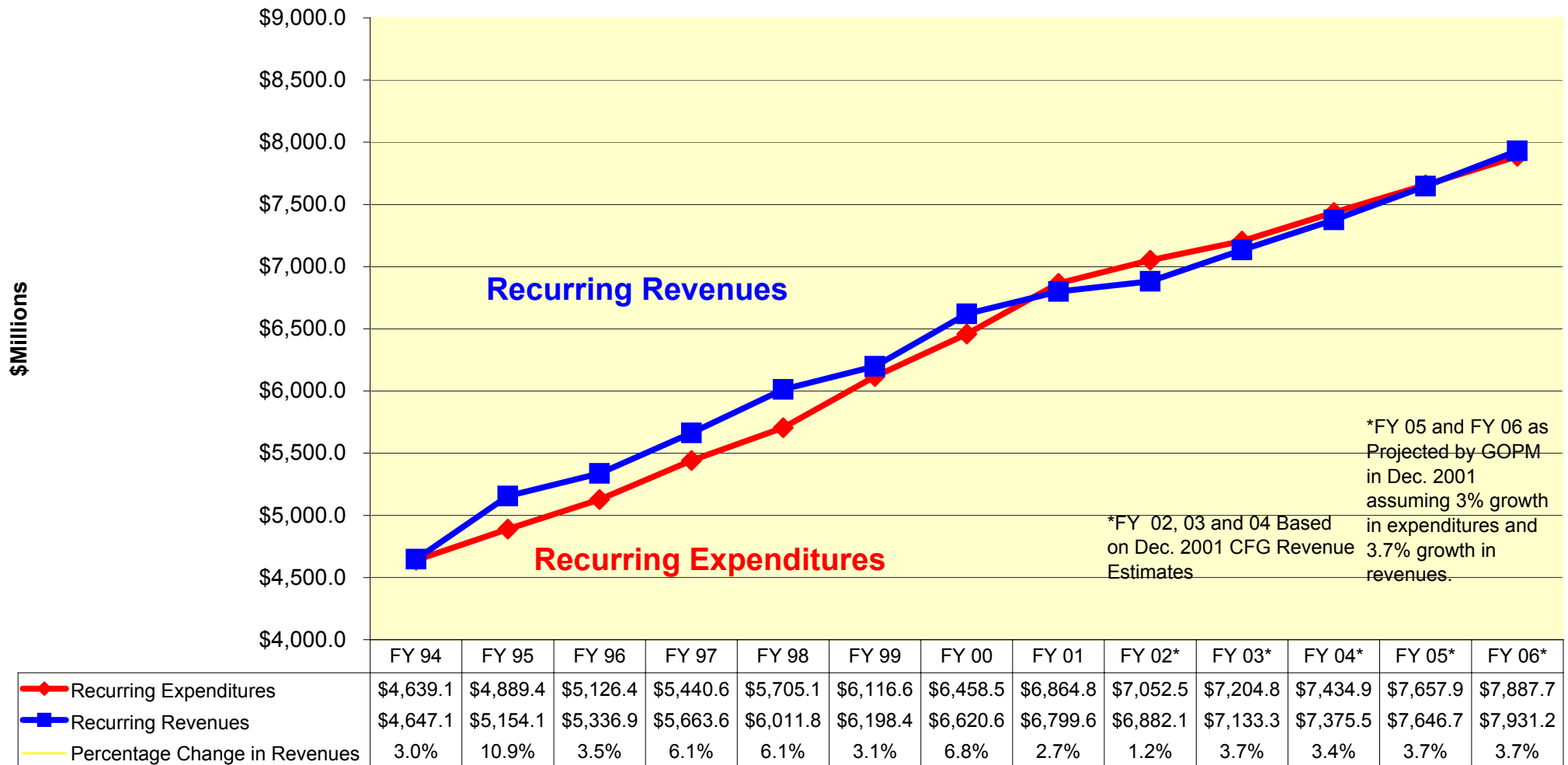
The starting point for the estimation of revenue for FY 03 and FY 04 was the official Consensus Forecasting Group (CFG) estimate of the FY 02 revenue made in December 2001. In making a revenue estimate, the CFG analyzes every element of the state's revenue stream and estimates an actual dollar amount for that source. The final estimate is the total dollar amount of each of these revenue streams, which is then translated into a percent increase above the actual or

## GRAPH 2

### Recurring General Fund Revenues and Recurring Expenditures (FY 94 - FY 06)

As Estimated In December of 2001

(Actual amounts from FY 94-01. Estimated amounts from  
FY 02-04. Projected amounts for FY 05 & FY 06)



estimated revenue for the previous year. The FY 03 revenue estimate was for a 3.3 percent growth over the estimated FY 02 revenue and the FY 04 revenue was for a 4.1 percent growth over the estimate of FY 03 revenue. While these estimates appear to be conservative, the percent growth number is very deceptive because the actual FY 02 revenue was \$159.4 million or 2.2 percent below the December 2001 estimate. The fact is, because the starting point for the FY 03 estimate was the FY 02 revenue, the FY 03 budget as implemented in the Governor's spending plan started off about \$155 million in the hole and would require an 8 percent increase in recurring resources to fully fund the "budgeted" FY 03 expenditures. This shortfall carries over into FY 04.

The recurring expenditure budget for FY 03 and FY 04 anticipates an increase in spending of 2.7 percent in FY 03 expenditures over FY 02 expenditures as they were expected to be in December of 2001 and 3.4 percent increase of FY 04 expenditures over FY 03 proposed expenditures. Based on the December 2001 revenue estimates, there was a \$120.0 million structural deficit in FY 03 and a \$121.1 million structural deficit in FY 04. These structural deficits were funded using non-recurring funds.

#### The Situation Today

In October of 2002 Governor Patton asked the CFG to re-estimate revenue for FY 03 and FY 04 and to project revenue for FY 05 and FY 06. The new official revenue forecast issued in November 2002 makes it apparent that the scenario anticipated by the administration in December of 2001 will not materialize. Graph 3 portrays the current financial situation of the Commonwealth as of November 2002 based on the latest CFG estimates. This graph vividly illustrates the structural deficit. There is no way to delay the hard choices that must be made; more revenue or drastic cuts in state services.

Table 1 details the situation as the administration currently sees it. This includes providing funding to the Department of Education for school districts at the levels set forth in the Executive Spending Plan for FY 03 and HB 1 in FY 04. The projections for FY 03 and FY 04 indicate that a cut in expenditures of \$144 million (2.1 percent) will have to be made late in FY 03 and a huge cut in expenditures of \$365 million (5.2 percent) in FY 04 will be necessary unless more revenue is generated.

This evaluation does not take into account the need to balance the budgets for two vital programs. These are \$135 million in FY 04 in state funds which will match the \$315 million in federal funds needed to continue the current level of services in Medicaid and \$6 million in FY 03 and \$11 million in FY 04 to fund an increase in prisoners incarcerated by the state beyond anticipated amounts. This data is summarized near the bottom of Table 1. These amounts are not added to the administration's evaluation of what we need to meet our current commitments because both the administration and the legislature were aware that a Medicaid

### GRAPH 3

## Recurring General Fund Revenues and Recurring Expenditures (FY 94 - FY 06) As Estimated In November of 2002

(Actual amounts from FY 94-02. Estimated amounts from  
FY 03-04. Projected amounts from FY 05 & FY 06)

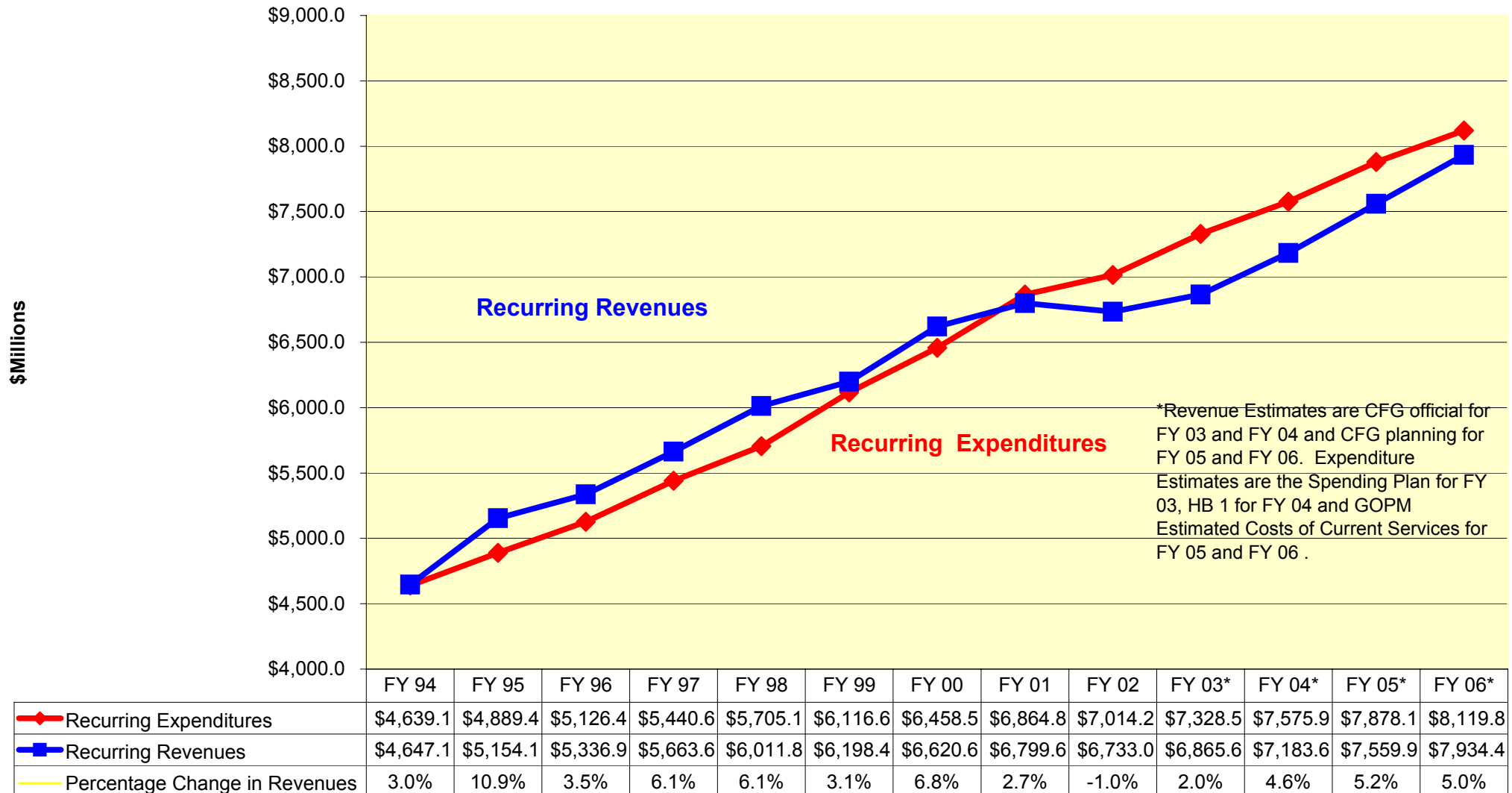


TABLE 1

**Estimated General Fund Budget Shortfall**  
**FY 03 - FY 04**  
**\$Millions**

	<b>FY 03</b>	<b>FY 04</b>
<b>Revenues</b>		
Dec. 2001 Official Consensus Forecasting Revenue Estimate	\$ 6,937.90	\$ 7,219.60
Nov. 2002 Official Consensus Forecasting Revenue Estimate	\$ 6,768.20	\$ 7,033.40
CFG Revenue Shortfall	\$ (169.70)	\$ (186.20)
Other Revenue Adjustments	\$ (30.10)	\$ (16.90)
<b>Total Revenue Shortfall</b>	<b>\$ (199.80)</b>	<b>\$ (203.10)</b>
 <b>Budget</b>		
Plus Necessary Government Expenses	(\$15.00)	(\$15.00)
Plus Dept. of Education Budget Shortfall	(\$56.40)	(\$59.60)
Less Possible One-Time Funds Identified	\$120.00	
Plus Campaign Finance Funds	\$7.00	\$2.00
Plus No Carryforward as Planned		(\$79.50)
Plus Shortfall of Fund Transfers (Planned Transfers of \$81.4 million in HB 1 will be \$71.54)		(\$9.86)
<b>Total Budget Shortfall</b>	<b>\$ (144.20)</b>	<b>\$ (365.06)</b>

**Other Expenditure Shortfalls**

Corrections	\$ 6.00	\$ 11.00
Medicaid (Estimated Total Funds Shortfall of \$450 million)	\$ -	\$ 135.00

**Impact of Across-the-Board Cuts**

Excluding Debt Service	2.1%	5.2%
Excluding Debt Service and K-12 Education	3.7%	9.1%
Excluding Debt Service, K-12 Education, and Corrections	3.9%	9.9%
Excluding Debt Service, K-12 Education, Corrections, and Medicaid	5.0%	12.4%
Excluding Debt Service, K-12 Education, Corrections, Medicaid, and Postsecondary Ed.	8.1%	20.5%

shortfall of approximately \$216 million was anticipated. The only difference between now and then is the magnitude. An increase in the number of incarcerated individuals was anticipated, yet the unanticipated downturn in the economy has resulted in greater numbers of prisoners. It is anticipated that the administration will take whatever action is necessary to keep the population at a level that can be funded in the current, or reduced, budget.

This evaluation does include an increase in the current appropriation for basic SEEK of \$56.4 million in FY 03 and \$59.6 million in FY 04 because the appropriation in the FY 02-04 "budget" is short of what is required to fully fund the basic SEEK authorization of \$3,049 per pupil in Average Daily Attendance (ADA) in FY 03 and \$3,234 per pupil in ADA in FY 04. In past budgets the appropriation to fund the per pupil in ADA has been larger than needed. This surplus has generally been given to the school districts. The administration believes that the per pupil in ADA is the promise made to school districts. If the legislature wants to give the school districts any surplus, that is a gift, but we believe we have a good faith obligation to fully fund the promised per pupil in ADA. To not increase this appropriation to Basic SEEK is to cut schools below what they have been promised and what they are operating on this fiscal year.

The administration is still searching for ways to reduce the budget shortfall in FY 03 but it is obvious that the long-term maintenance of current programs with current revenue is not feasible because there are no more non-recurring funds to finance the projected structural deficits in FY 04, FY 05 and FY 06.

#### This Budget Crisis is Different from Previous Budget Crises

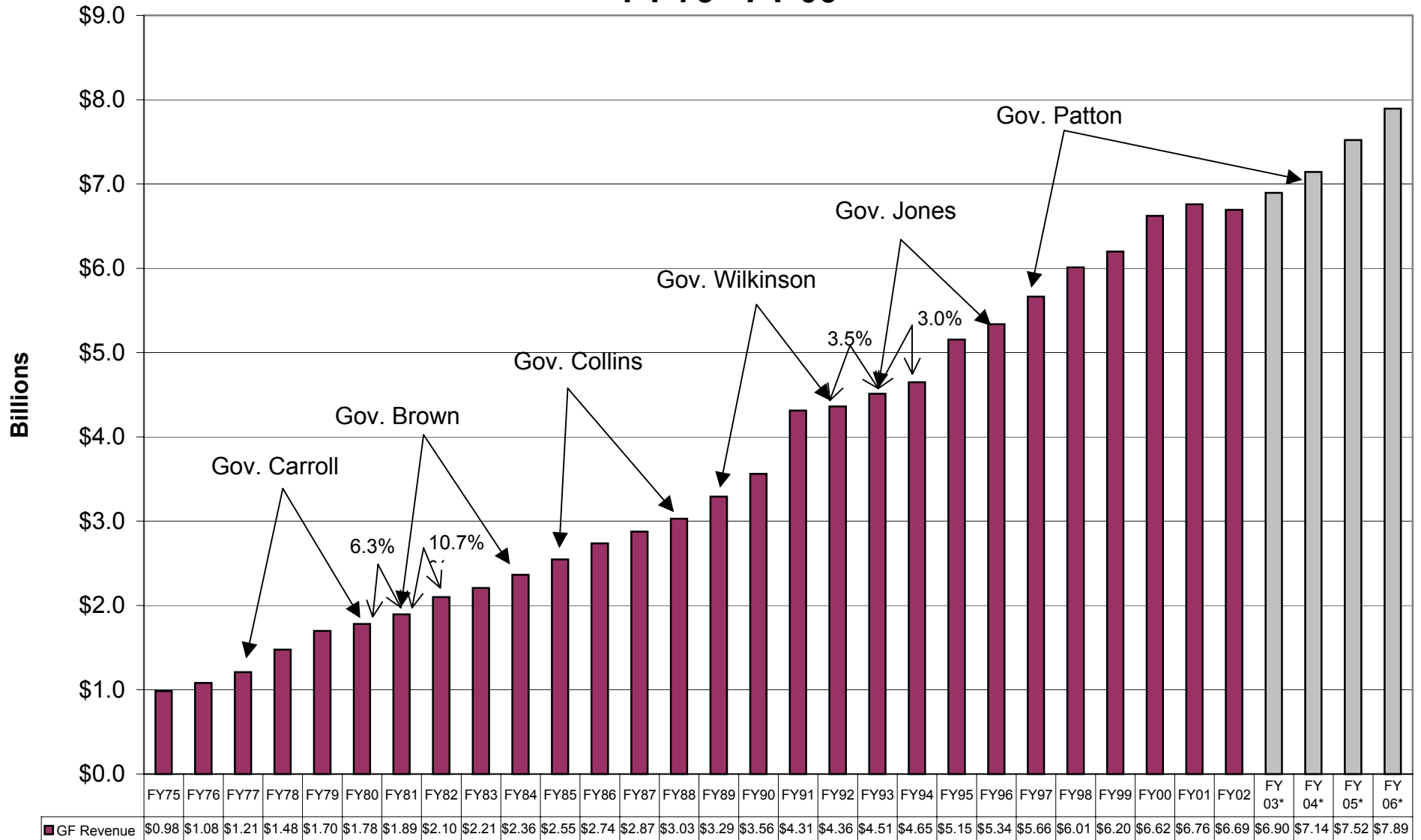
Graph 4 portrays total General Fund revenue from FY 75 projected through FY 06. Note that there is no dramatic feature in this graph during the Brown budget crises (FYs 81 and 82). Likewise, the years of the Jones budget crises (FYs 93 and 94) are not particularly dramatic.

There are three features of this graph which are particularly interesting. One is the dramatic revenue increase in FY 91, the KERA tax increase, then very little growth in FY 92 (1.2 percent), the budget for the last half-year of the Wilkinson Administration and the first half-year of the Jones Administration. There was moderate revenue growth in FYs 93 and 94. The average annual growth of revenue from FY 91 to FY 94 was an anemic 2.6 percent per year.

The second unusual feature of Graph 4 is the dramatic growth in FY 95, which was sustained at an annual growth rate of 5.2 percent through FY 00. This substantial and sustained increase in revenue was not forecasted as Governor Jones prepared his last biennial budget for the 1994 session of the General Assembly and in fact was not fully recognized or budgeted in Governor Patton's first biennial budget in the 1996 session. This unbudgeted increase in revenue was the foundation of Governor Jones' surpluses and Governor Patton's two very

GRAPH 4

# General Fund Receipts FY 75 - FY 06\*



\*FY 03 - FY 06 Estimated by CFG 11/15/02  
Numbers include Tobacco Receipts

strong biennial budgets passed in the 1998 and 2000 sessions of the General Assembly.

The third unusual feature of this graph, and the one which is the focus of this report, is the dramatic shift of revenue to a permanently lower growth path from FY 01 to FY 03. This shift has created a permanent gap between current commitments and current revenue that cannot be bridged absent some dramatic action. The average recurring revenue growth over the period FY 01 through FY 03 is forecasted to be .5 percent. The cost of continuing current services during this time frame is estimated to increase on average 3.4 percent per year.

According to the CFG, revenue should begin to grow again in FY 04 at an average annual rate of 3.9 percent. While encouraging, this does not solve the structural problem. That problem is, just as revenue shifted to a higher growth path in FY 95, permitting substantial increases in services at the same time that \$469.7 million in tax cuts were being implemented, revenue has now shifted to a lower growth path, requiring cutbacks in services, or the restoration of revenues on the magnitude of the tax cuts implemented during the strong economy.

The state has two choices: make dramatic cuts in programs, including education (about a 5.2 percent across-the-board cut); or sustaining current services by increasing GF revenue by about \$400 million, or a combination of both.

## Revenue

While Kentucky's tax revenue, both General Fund (GF) and Road Fund (RF), grew during the mid-90s, it did NOT grow as fast as most other states (Graph 5). The national average annual growth of state revenue generated by all taxes was 5.8 percent from FY 95 through FY 01 while Kentucky's average annual rate of tax-generated revenue growth was 3.8 percent. This was less than all of Kentucky's neighbors and less than 43 of the 50 states. This indicates that Kentucky has a structural problem with the growth rate of its tax revenue-generating program which, if not corrected, will cause the Commonwealth to fall behind its competitor states.

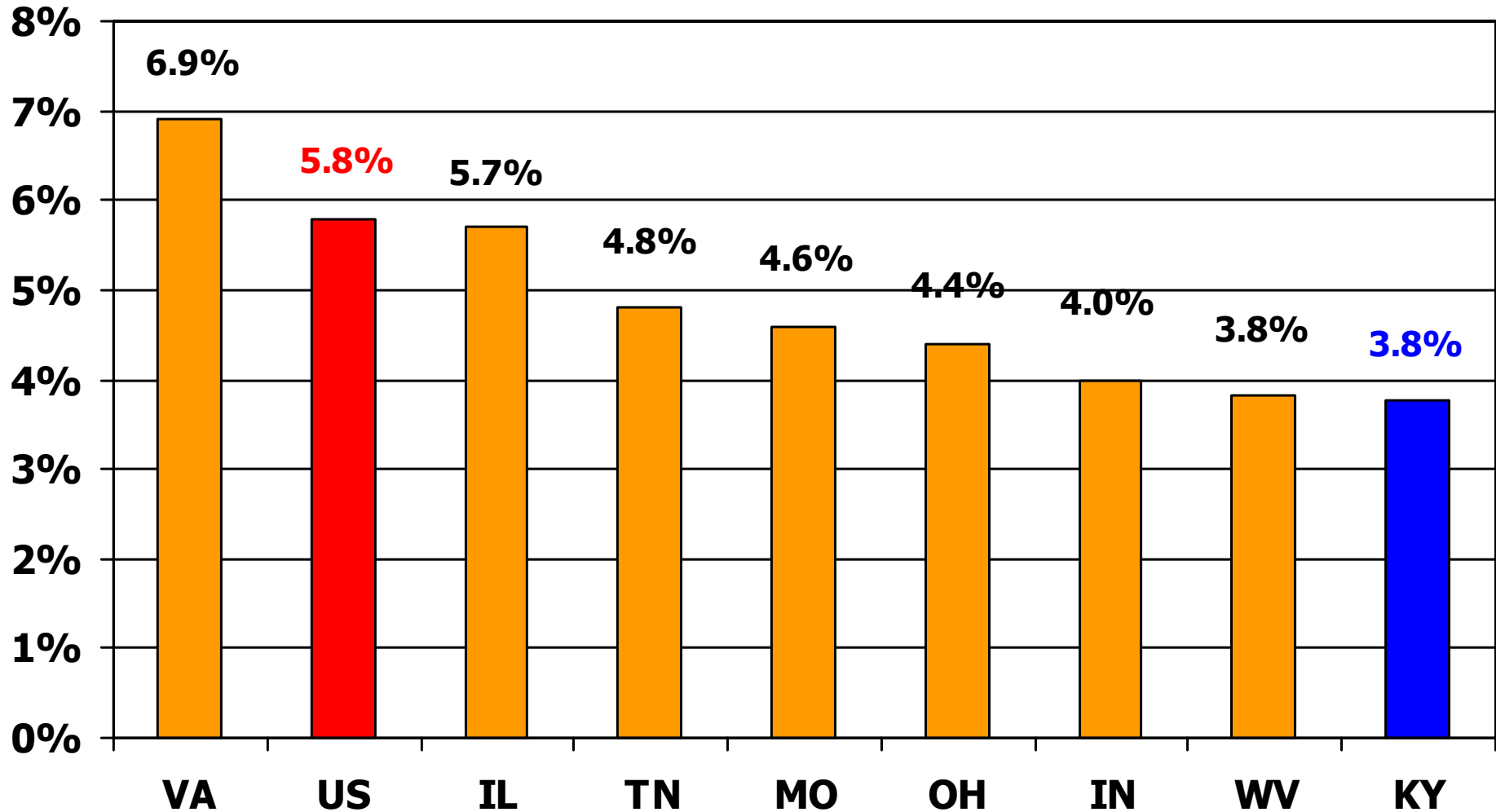
## General Fund (GF)

Most state services (with the exception of roads) are paid for from the GF. In addition to tax revenue, the GF includes other revenues such as the tobacco settlement proceeds, lottery dividends, investment income, penalties, interest, court fines, and other miscellaneous non-tax revenues. From FY 96 to FY 02, General Fund revenue<sup>3</sup> increased \$1.3561 billion, an increase of 25.4 percent, an average of 4.2 percent per year.<sup>4</sup>

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<sup>3</sup> General Fund revenue in this report means current year revenue directly into the General Fund for General Fund purposes. It does NOT include funds lapsed from the prior year, transfers from the Budget Reserve Trust Fund,

# Change in State Tax Revenue FY95 to FY01 (Annual Average)



“Tax Revenue” includes both General Fund and Road Fund.

Source: U.S. Bureau of Census

## Spending

Kentucky increased GF spending on on-going programs from FY 96 to FY 02 by \$1.8887 billion, a 36.8 percent increase, an average of 6.1 percent per year.

A logical question to ask is how is it possible that from FY 96 to FY 02 average annual GF expenditures grew at a rate of 6.1 percent while average annual revenues grew only 4.2 percent, a difference of \$531.7 million. The simple explanation is structural deficits. The FY 96 budget included \$159.6 million for non-recurring expenditures and a \$50.9 million surplus. This allowed \$210.5 million of non-recurring resources to be spent on recurring expenditures. In addition to this reserve capacity to increase spending on recurring programs, the FY 02 budget cut of \$349.8 million was not enough to bring recurring expenditures in line with recurring revenue. Non-recurring resources of \$240 million from the BRTF and \$97.3 million in fund transfers were used to prevent even larger cuts in the FY 02 budget.

The on-going programs which received major increases in funding between FY 96 and FY 02 were the criminal justice system, 74 percent; Medicaid, 63 percent; education, 29 percent; and new programs funded by tobacco settlement monies. The rest of government, which is only 20 percent of total General Fund expenditures, grew only 13 percent, exclusive of debt service, an average of 2.2 percent per year. Graph 6 illustrates spending in these categories from FY 85 through FY 02 with budgeted expenditures for FY 03 and FY 04.

Graph 7 breaks down the other 20 percent of GF expenditures by cabinet and major program and portrays the percent of each of these areas as a percent of total GF expenditures for FY 02. While the Patton Administration has been able to increase state government support for major state programs, it has held the line on most parts of state government directly administered by the Governor and employing most of state personnel.

Kentucky was very wise to spend some of the revenue being generated in the mid-90's on non-recurring capital investments because it was obvious that the economy could not stay strong indefinitely. The areas where we did increase our commitment, prisons, Medicaid and education, are vital to our future prosperity and health and safety. Other states did commit most of their increased revenue to new programs and are therefore in much worse shape than Kentucky.

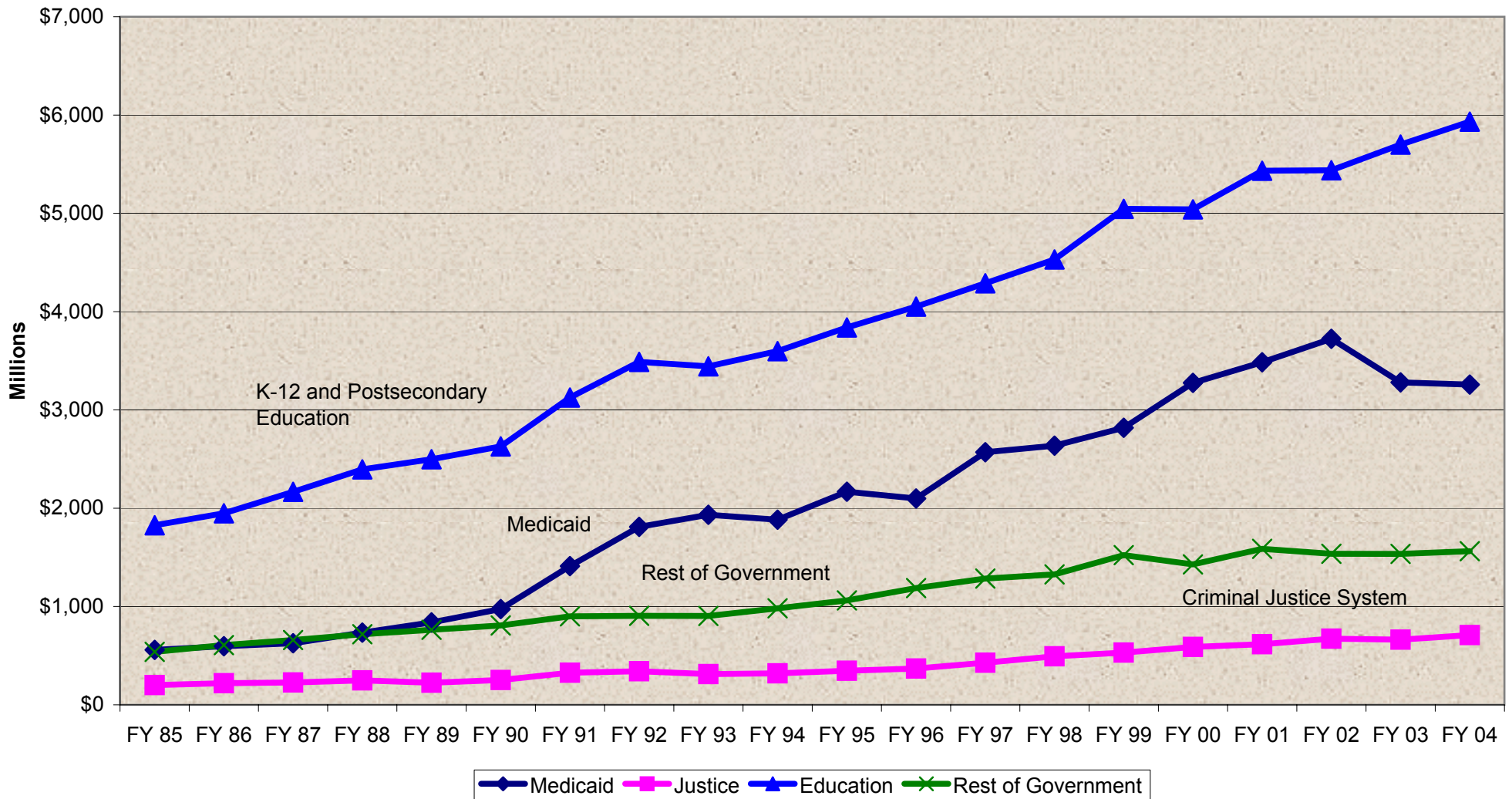
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unspent funds from prior years carried over into the current year or fund transfers. General Fund expenditures will INCLUDE these items but will not include funds lapsed into the next year.

<sup>4</sup>The 4.2 percent GF revenue growth is different than 3.8 percent tax-generated revenue growth referred to in Graph 5 for several reasons. Among them are the time period is different, the Graph 5 data does not include non-tax generated revenue such as the tobacco settlement proceeds and the lottery, and Road Fund tax revenue grew slower during this period than GF tax revenue.

**GRAPH 6**

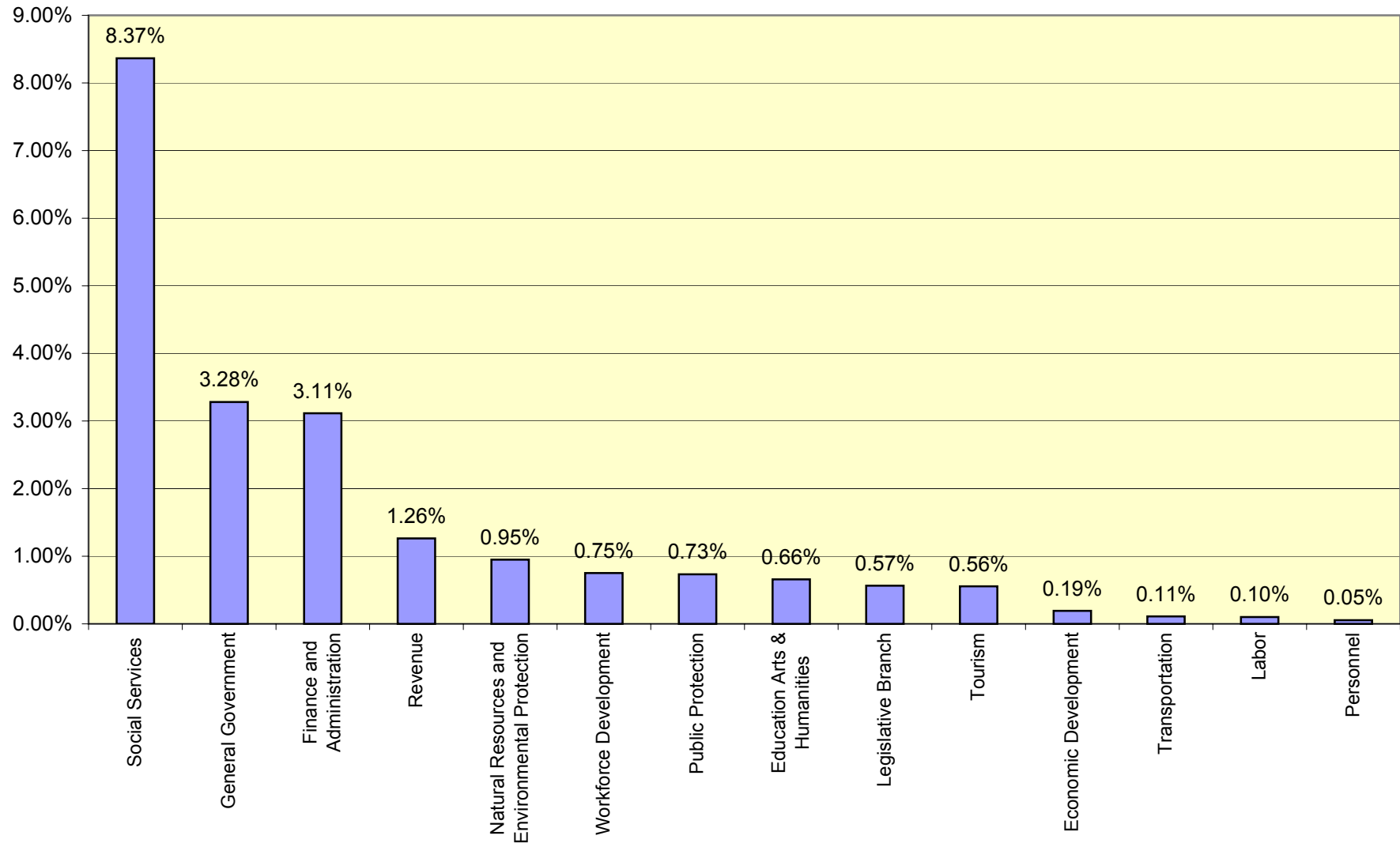
**Kentucky Expenditure Trends in Education, Medicaid, Criminal Justice Systems, and the Rest of Government  
FY 85 - FY 04\***



Notes: FY 03 and FY 04 reflect Spending Plan and HB 1.  
 K-12 includes state and local spending and Postsecondary includes GF spending;  
 Justice and Rest of Govt. include GF Spending.

**GRAPH 7**

**Rest of Government Expenditures as a % of Total General Fund Expenditures in  
FY 02**



Note: Social Services includes Families and Children and Health Services less Medicaid.

One-time capital investment spending (not including bonded investment) from FY 96 to FY 02 totaled \$1.1 billion and the total accumulated in the BRTF by the beginning of FY 01 was \$278.8 million. There was also about \$400 million of surplus funds in various dedicated use funds such as the Petroleum Storage Tank Fund and the Kentucky Access Fund.

#### Budget Reserve Trust Funds (BRTF)

The purpose of a BRTF is to see a state through a slow-down in revenue growth without cutting services to its citizens. That's what Kentucky has done but now our budget reserve is exhausted. When this happens, it is vitally important that the state begin to systematically rebuild its BRTF. Our statutory target for a balance in the BRTF is 5 percent of GF revenue, which we have never reached. The current fiscal condition of the state is worse than the administration thought it would ever get. This current crisis demonstrates the wisdom of a 5 percent BRTF.

In addition to a specific appropriation to the BRTF, all surplus funds should be automatically appropriated to the BRTF until it is adequately replenished. But Kentucky will not return to a level of revenue adequate to meet its commitments unless it modernizes its revenue-generating program to reflect the realities of our modern economy.

#### Causes of this Crisis

One could conclude that revenue shortfalls are simply the result of overly optimistic revenue estimates. Before the initiation of the CFG process, that would probably be a valid conclusion. From FY 81 through FY 94 Kentucky had nine revenue shortfalls. A review of revenue for these years reveals relatively consistent increases in revenue from year to year. The shortfalls were more likely caused by a desire to stretch revenues to meet spending demands.

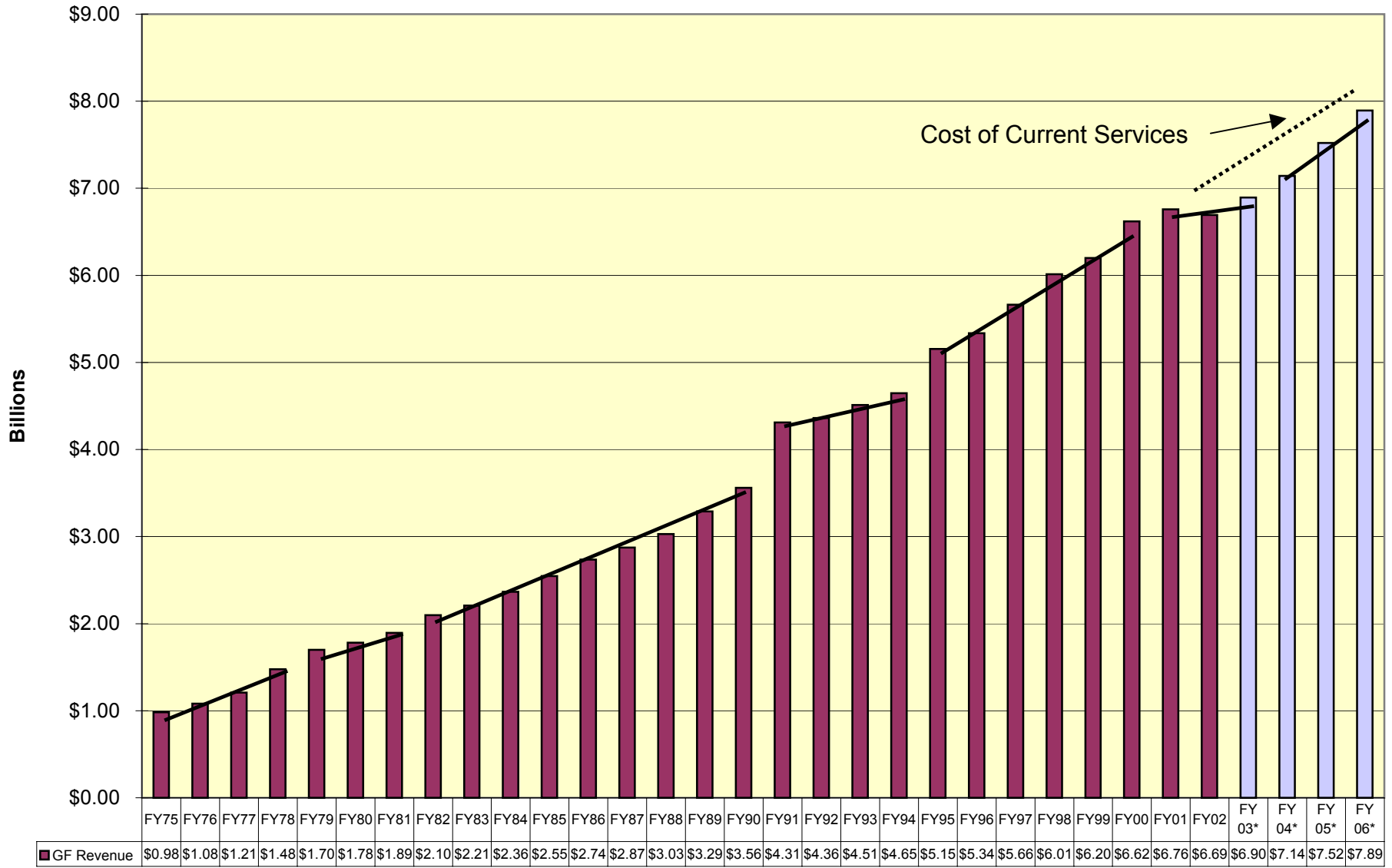
The CFG process began in 1994 and was first used to construct the FY 95-96 budget. This process is independent of the executive and legislative branches of government and by design, conservative. The first six budgets constructed using the CFG process produced surpluses. While the process is far from perfect, it is not influenced by spending demands.

From the experience of Kentucky and many other states it appears that this particular recession has affected state revenues much more dramatically than previous recessions. Revenue forecasters are rethinking their economic models and other forecasting techniques. Many states are reviewing their revenue-generating systems to determine if their problem is an outdated tax code.

Stability is a very desirable characteristic of a state revenue-generating system. Graph 8 portrays total GF revenue in Kentucky from FY 75 through FY 02 with estimates and projections through FY 06. It is obvious from the trend lines on

GRAPH 8

General Fund Receipts  
FY 75 - 06\*



Note: Includes Tobacco Receipts  
FY 03 - FY 06 As Estimated By CFG on 11/15/02

the graph that Kentucky's revenue-generating system produces erratic results. Erratic revenue results in erratic government actions which contribute to inefficiency. Stability of revenue promotes stable and more efficient government. It is obvious that any attempt to reform Kentucky's tax code should place great emphasis on stability and consistency in the generation of revenue. Graph 8 demonstrates that revenue growth in Kentucky has followed relatively consistent growth paths over a span of a few years and then changed to follow a different growth path. Some of these shifts in the revenue growth path are because of deliberate legislative actions. Some of this erratic behavior is the result of the structure of our tax code and could be reduced.

From FY 75 through FY 78 (roughly the Julian Carroll years) revenue growth was relatively consistent from year to year and very strong. This coincides with the coal boom which came to an end about 1980.

From FY 79 through FY 81 (the early part of the Brown Administration) growth was slower than it had been, a reflection of the fading coal boom and the recessionary years of 1981 and 1982.

From FY 82 through FY 90 (from the middle of the Brown Administration to the middle of the Wilkinson Administration) revenue grew fairly consistent at an average of about \$180 million a year, 6.8 percent per year.

During FY 91, the KERA tax increases went into effect. These increases were designed to generate more money in that year (\$646.3 million) than it would generate in FY 92 (\$605.9 million) and subsequent years.

As will be discussed later, the KERA tax increases didn't generate as much revenue as predicted (and budgeted), but they did result in a huge jump in revenue in FY 91, followed by relatively flat growth for the next three years (through FY 94), the first half of the Jones Administration. This slowdown was partly a function of the way the KERA tax increases were implemented and partly the result of the 1991-92 recession. State revenue recovery generally follows economic recovery by a year or two.

The years FY 95 through FY 00 were good years that moved the GF revenue growth path to a higher level. Revenue in FY 95 increased dramatically and unexpectedly, \$174.4 million more than budgeted in the biennial budget enacted by the 1994 General Assembly. In FY 96, revenue was \$147.0 million more than budgeted.

These excess revenues in FY 95 (the last full fiscal year of the Jones Administration) and FY 96 (the last half-year of the Jones Administration) is where a lot of the money in the BRTF came from and the basis upon which Governor Jones secured the passage of tax cuts in special sessions in 1995. None of these tax cuts actually affected the budgets of Governor Jones. They were phased in

during the first four years of the Patton Administration. During the Patton Administration other tax cuts were implemented by executive action or legislative action and generally phased in over four years. Other cuts in taxes were ordered by the courts. (See Table 2.) These tax cuts will total \$484.7 million in FY 04.

One could conclude that these tax cuts are the root of our problem. That is not the case. Revenue growth during this period was adequate. If the state had realized this revenue it would have been spent, most likely, on on-going programs. Sending the excess revenue back to the people was not a mistake. In retrospect, perhaps this should have been as a refund, not a permanent tax cut.

One of the real causes of the current dilemma in Kentucky is that the tax increases of 1990 to pay for KERA did not generate the revenue anticipated and did not adequately finance the increased commitment to KERA and related programs.

The 1990 tax increase was promoted as \$605.9 million a year when fully implemented in FY 92, an increase in General Fund revenue of 15.8 percent. It actually generated about \$519.3 million in FY 92, a 13.5 percent increase, a shortfall of \$91.6 million, about 2.1 percent of expected General Fund revenue in FY 92. This 2.1 percent shortfall would be about \$150 million in FY 04. At the same time, the increase in commitment in FY 92 was \$671.0 million instead of the anticipated \$605.9 million increase in revenue. This \$65.1 million over-commitment, 1.5 percent of the budget, translates into about \$113 million in FY 04. In FY 04, these two factors contribute \$263 million to the present budget shortfall.

Another cause of our budget problem is the lack of growth of the corporate income tax and license tax as a source of support for KERA. The business community was the prime driver behind KERA because they knew Kentucky had to have a better-educated workforce to compete in the world economy. The 1990 tax increases included raising the sales and use tax from 5 to 6 percent (a 20 percent increase), made several changes in the individual Income Tax Code (an increase of about 22.0 percent) and the increase of the corporate income tax from 7.25 to 8.25 percent (a 13.8 percent increase).

Graph 9 shows the individual income tax, the sales and use tax, the corporate income tax and license tax, property tax, and other tax revenue actually collected from FY 81 through FY 02 with estimates and projections through FY 06.

From FY 90 to FY 02, the individual income tax collected increased 123 percent. The sales and use tax collected increased 112 percent. The property tax increased 43.3 percent. Other taxes increased 31.1 percent. The corporate income and license tax collected decreased 8.4 percent. Had the corporate taxes increased 117.5 percent, the average of the sales and use tax and individual income tax, then the additional taxes collected would have been \$416.9 million, enough to address Kentucky's current revenue problem.

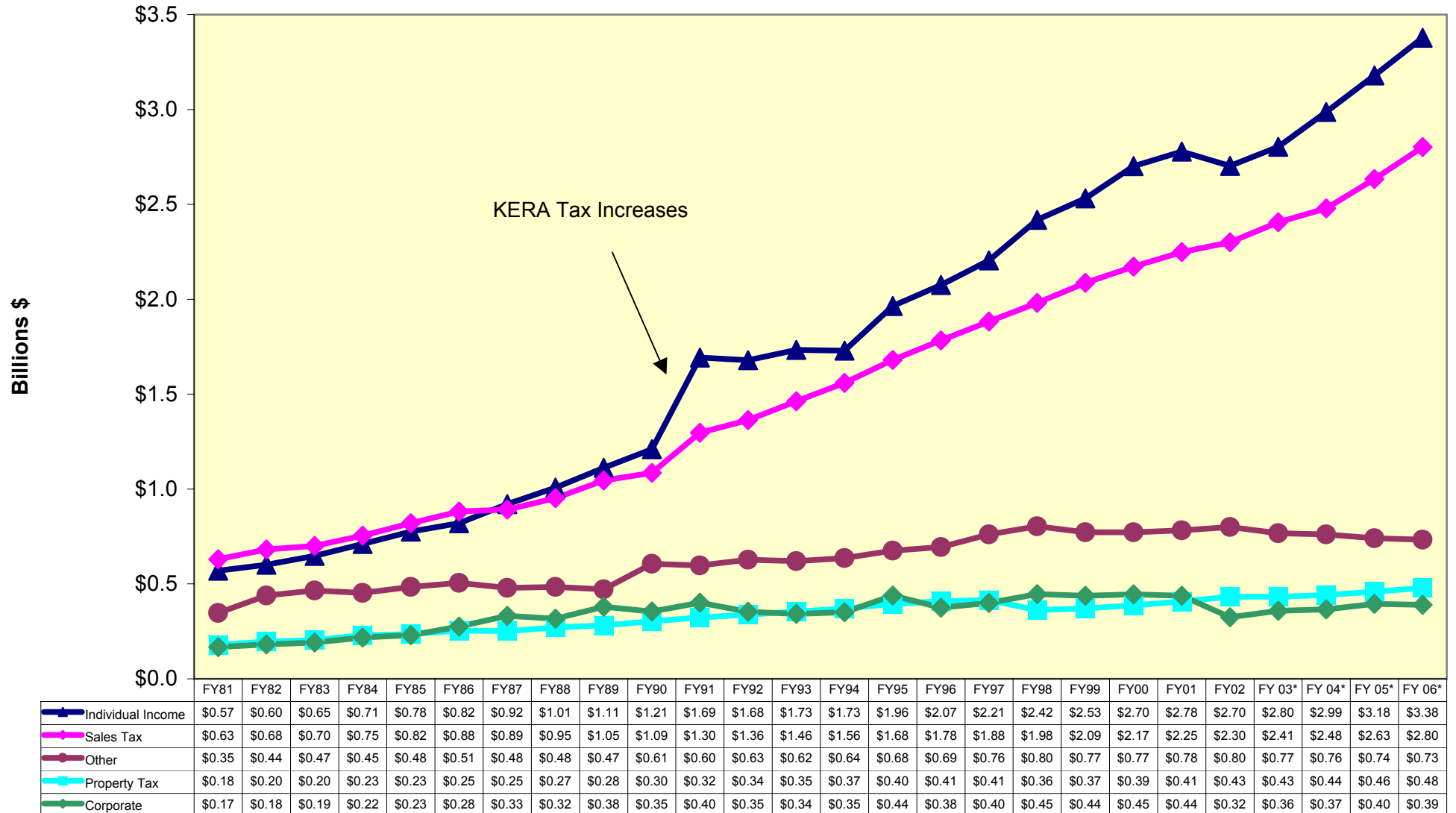
**TABLE 2**  
**Tax Reduction Measures**

(millions of dollars)

	FY96	FY97	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06
<b>Income Tax and Inheritance</b>	<b>-27.1</b>	<b>-55.5</b>	<b>-98.3</b>	<b>-131.2</b>	<b>-161.1</b>	<b>-167.0</b>	<b>-194.6</b>	<b>-218.8</b>	<b>-245.3</b>	<b>-258.4</b>	<b>-272.7</b>
Private pension & IRA exemption	-27.1	-45.3	-63.5	-72.7	-76.1	-79.6	-83.5	-86.8	-90.3	-95.4	-100.9
Inheritance tax exemption	-	-6.0	-21.0	-33.6	-50.3	-51.7	-74.2	-83.1	-93.1	-98.3	-104.0
Standard deduction increased to \$1,700	-	-4.2	-13.8	-24.9	-34.7	-35.7	-36.9	-37.6	-38.5	-40.7	-43.0
Federal Estate Tax Changes								-11.3	-23.4	-24.1	-24.8
<b>Health Related</b>	<b>0.0</b>	<b>-10.0</b>	<b>-21.0</b>	<b>-32.5</b>	<b>-52.6</b>	<b>-64.3</b>	<b>-74.7</b>	<b>-80.3</b>	<b>-85.8</b>	<b>-92.0</b>	<b>-98.6</b>
Health insurance deduction (reduces income tax)	-	-	-	-	-2.0	-2.0	-7.9	-8.0	-8.2	-8.8	-9.4
Deduction for long term care (reduces income tax)	-	-	-	-1.2	-1.2	-1.2	-1.2	-1.2	-1.4	-1.5	-1.6
Provider tax exemption on physicians	-	-10.0	-21.0	-31.3	-44.4	-48.1	-51.6	-56.0	-60.0	-64.3	-68.9
Provider tax exemption for prescription drugs	-	-	-	-	-5.0	-13.0	-14.0	-15.1	-16.2	-17.4	-18.6
<b>Automobile</b>	<b>0.0</b>	<b>-9.5</b>	<b>-13.8</b>	<b>-18.3</b>	<b>-19.2</b>	<b>-20.2</b>	<b>-21.2</b>	<b>-22.2</b>	<b>-23.3</b>	<b>-24.5</b>	<b>-25.7</b>
Marcum: Property tax on automobiles	-	-9.5	-9.8	-10.3	-10.8	-11.3	-11.9	-12.5	-13.1	-13.8	-14.5
Automobile property tax cut	-	-	-4.0	-8.0	-8.4	-8.8	-9.3	-9.7	-10.2	-10.7	-11.3
<b>Agriculture</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>-1.0</b>	<b>-1.0</b>	<b>-1.2</b>	<b>-1.2</b>	<b>-1.2</b>	<b>-1.2</b>	<b>-1.2</b>	<b>-1.2</b>
Sales tax exemption for farm fuel	-	-	-	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0
Domestic cervids operations granted sales tax exemption		-	-	-	-	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
<b>Business</b>	<b>0.0</b>	<b>-1.0</b>	<b>-31.0</b>	<b>-36.2</b>	<b>-42.9</b>	<b>-56.2</b>	<b>-66.4</b>	<b>-65.8</b>	<b>-67.9</b>	<b>-69.9</b>	<b>-71.8</b>
Private aircraft taxed at lower property tax rate	-	-	-	-0.7	-0.7	-0.7	-1.1	-1.1	-1.1	-1.1	-1.2
Investment Fund & Training (reduces income tax)	-	-	-	-1.0	-6.0	-8.5	-11.0	-11.0	-11.0	-11.3	-11.6
St. Ledger: Equal treatment of stock	-	-1.0	-31.0	-32.6	-34.2	-35.9	-37.7	-39.6	-41.5	-42.8	-43.9
Bank Franchise Tax: method changed	-	-	-	-2.0	-2.0	-2.0	-2.0	-2.0	-2.0	-2.1	-2.1
Jet fuel tax credit for large carriers	-	-	-	-	-	-6.0	-7.0	-6.0	-6.1	-6.3	-6.5
Historic buildings as lodgings given sales tax refund		-	-	-	-	-	-1.1	-1.1	-1.1	-1.1	-1.1
Seasonal employees considered "qualified" for KEZ		-	-	-	-	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4
Pari-mutuel tax credit		-	-	-	-	-0.7	-1.5	-	-	-	-
Retail metal fixture		-	-	-	-	-0.5	-0.5	-0.5	-0.5	-0.6	-0.6
Coal fired electric generation plants receive tax credits		-	-	-	-	-	-2.6	-2.6	-2.6	-2.7	-2.8
Coal mined from thin seams given tax credits		-	-	-	-	-1.0	-1.0	-1.0	-1.0	-1.0	-1.1
KIRA benefits to include corporate license tax		-	-	-	-	-0.5	-0.5	-0.5	-0.5	-0.5	-0.5
<b>Property Tax Reduction</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-1.2</b>	<b>-1.2</b>	<b>-1.2</b>	<b>-1.2</b>	<b>-1.2</b>	<b>-1.2</b>	<b>-1.2</b>
<b>Total General Fund Impact Taxes*</b>	<b>-\$27.1</b>	<b>-\$66.0</b>	<b>-\$143.1</b>	<b>-\$187.9</b>	<b>-\$228.6</b>	<b>-\$248.9</b>	<b>-\$293.7</b>	<b>-\$318.4</b>	<b>-\$348.5</b>	<b>-\$365.6</b>	<b>-\$383.7</b>
<b>Non-General Fund</b>	<b>0.0</b>	<b>-29.0</b>	<b>-48.6</b>	<b>-82.2</b>	<b>-110.4</b>	<b>-146.4</b>	<b>-176.0</b>	<b>-128.9</b>	<b>-136.2</b>	<b>-144.0</b>	<b>-152.3</b>
Reduce taxable value of motor vehicles (use tax)	-	-	-	-6.8	-6.8	-6.8	-6.8	-6.8	-6.8	-6.8	-6.8
McGaren: Equalization of trade-in value	-	-	-	-	-	-3.3	-6.5	-6.5	-6.5	-6.5	-6.5
Local govt component of auto property taxes		-19.0	-27.6	-36.6	-38.4	-40.3	-42.3	-44.5	-46.7	-49.0	-51.5
Unemployment Insurance: Reduction in Employer Payment		-	-	-7.5	-15.7	-35.0	-54.8	-	-	-	-
<b>TOTAL ALL TAXES</b>	<b>-\$27.1</b>	<b>-\$95.0</b>	<b>-\$191.7</b>	<b>-\$270.1</b>	<b>-\$338.9</b>	<b>-\$395.4</b>	<b>-\$469.7</b>	<b>-\$447.3</b>	<b>-\$484.7</b>	<b>-\$509.6</b>	<b>-\$536.0</b>
<b>Cumulative All Taxes</b>	<b>-\$27.1</b>	<b>-\$122.1</b>	<b>-\$313.8</b>	<b>-\$583.9</b>	<b>-\$922.8</b>	<b>-\$1,318.2</b>	<b>-\$1,787.9</b>	<b>-\$2,235.1</b>	<b>-\$2,719.9</b>	<b>-\$3,229.5</b>	<b>-\$3,765.5</b>

## GRAPH 9

### General Fund Tax Receipts By Type FY 81 - FY 06\*



Note: Does Not Include Tobacco Receipts.

\*FY 03 - FY 06 CFG Estimates of 11/15/02.

Graph 10 shows these revenues as a percent of total GF revenue. This graph shows that the sales and use tax percent of total GF revenue has been fairly constant at about 33 percent. The Individual Income Tax revenue jumped from about 34 percent before the KERA tax increases to about 41 percent by FY 02. The other revenue streams declined from 17.0 percent in FY 90 to 12.2 percent in FY 02 and the corporate contribution to total GF revenue declining from 10 percent in FY 90 to 5 percent in FY 02.

In 1985, Kentucky passed the Kentucky Equity Tax Act (KETA) which had a stated goal to increase businesses' "fair share" of the overall tax burden and established 10 percent of GF revenue as that fair share<sup>5</sup>. If the corporate community's share had been 10.0 percent in FY 02, the increased revenue would have been \$331.2 million.

The fact is that corporations are now aggressively managing funds to minimize tax liabilities. The corporate income tax is no longer a reliable source of support for state government programs.

While a corporation operating in Kentucky will pay no corporate income tax if the corporation reports no profit, Kentucky's corporate license tax is designed to ensure that all corporations pay something to support the state government services like education and public protection upon which they depend. This tax is \$.21 for each \$100 of capital used in Kentucky, 0.21 percent. In 1996, Limited Liability Companies (LLCs) were exempted from this tax in Kentucky which means that a LLC can use sophisticated tax planning and avoid state tax liability while still receiving the benefit of state government services. It's not surprising that doing business as a LLC in Kentucky has skyrocketed. Graph 11 vividly illustrates that businesses are using this perfectly legal vehicle to reduce their support for state government.

Another cause of our revenue problem is the 2001 changes in the Federal Tax Code, in particular, the elimination of the deductibility of the Kentucky Estate Tax from the Federal Estate Tax. This will cost the Kentucky GF \$11.3 million in FY 03, \$23.9 million in FY 04, \$37.4 million in FY 05 and \$52.9 million in FY 06.

Another problem of the future is the Tennessee lottery which by FY 06 will reduce Kentucky lottery income to the General Fund by \$20.7 million.

On the positive side, the EMPOWER Kentucky initiative will save \$92.0 million in FY 04 and has saved a total of \$572.4 million from FY 97 through FY 04.

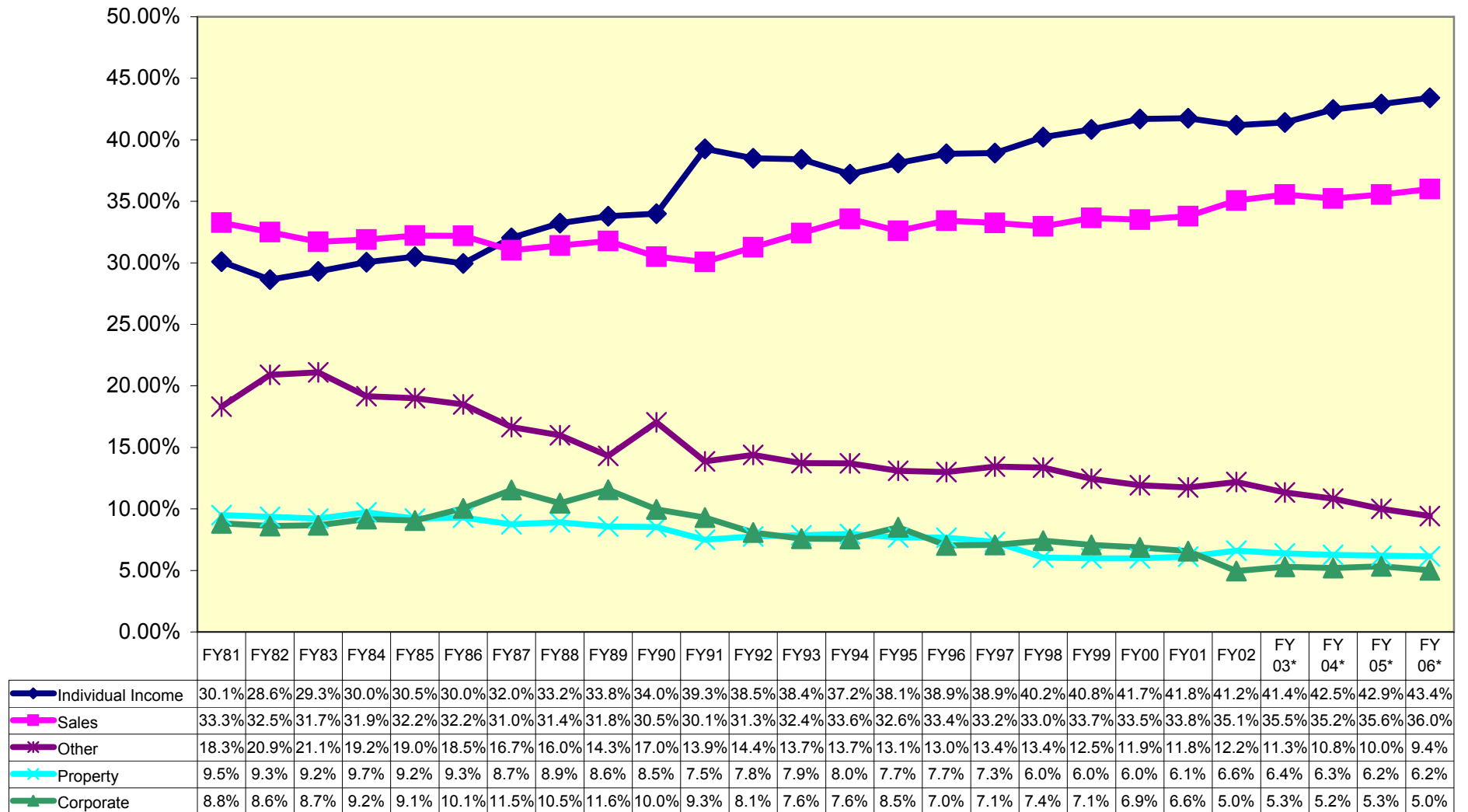
A fundamental reason for our revenue problem is our tax code. We have an obsolete revenue-generating system, one designed for the industrial economy

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<sup>5</sup>Source: "Revenue Estimates for the Biennium, July 1, 1990 – June 30, 1992, Adjusted for Legislation Enacted by the 1990 General Assembly," p. 10.

## GRAPH 10

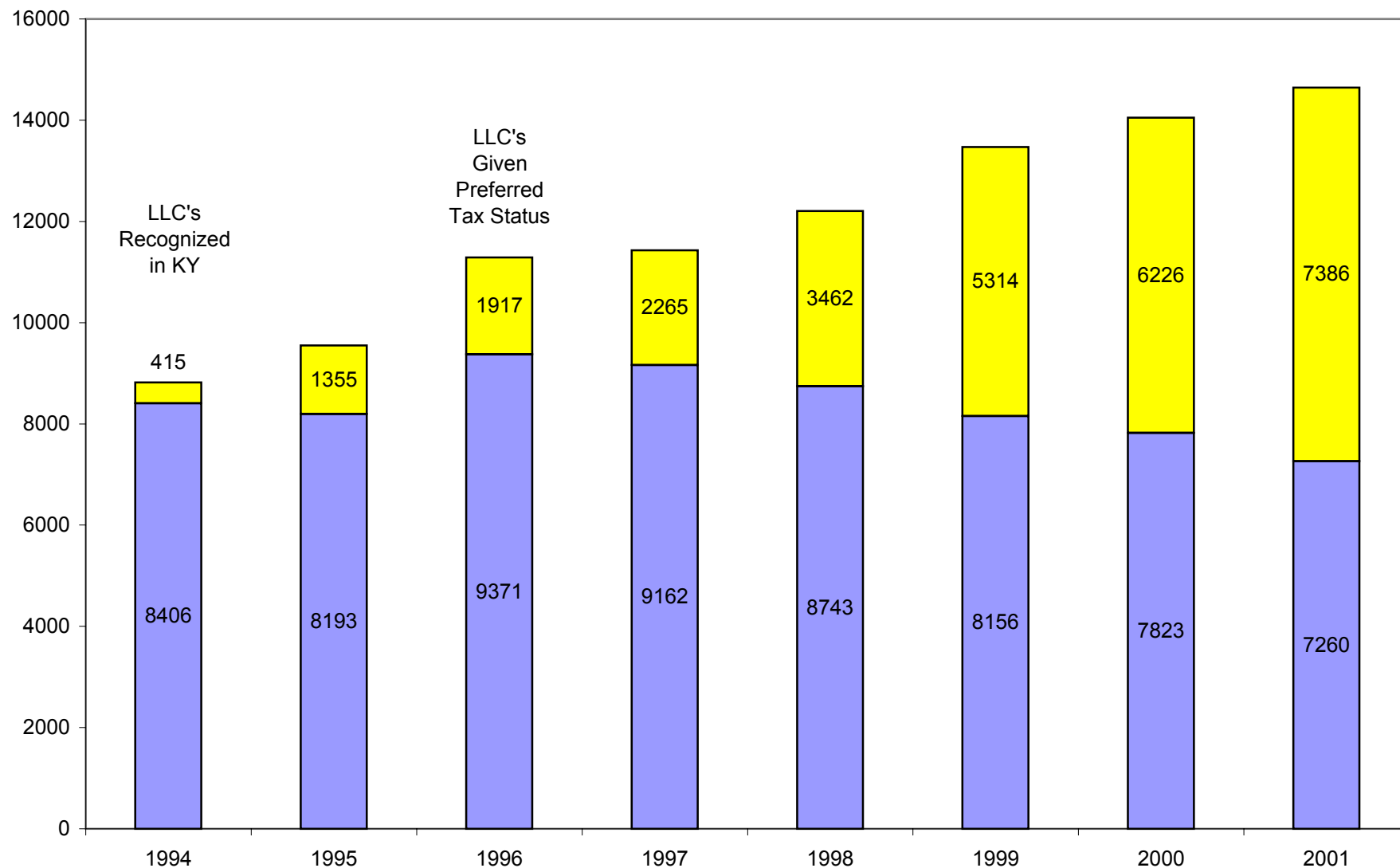
### Tax Receipts by Type as a % of Total General Fund Receipts FY 81 - FY 06\*



Note: Does not include Tobacco Receipts  
\*FY 03 - FY 06 CFG Estimates of 11/15/02.

## GRAPH 11

### Type of Organization of New Kentucky Companies



Note: Total active LLCs as of 10/02 are 28,950. Total active Corporations are 98,176, of which 18,227 are non-profit.

■ Domestic Corporation    ■ Domestic LLC

of 50 years ago. Kentucky must change its tax code to provide for more revenue growth and less revenue volatility or it will have chronic revenue problems and not be able to provide the services a knowledge-based economy needs.

One of the goals of a revised tax code should be to grow revenue as the personal income of Kentuckians grows. Inflationary growth will not do the job. A growing society needs increased services. State revenue growing as a society's personal income grows is not a tax increase.

A rational tax policy, once established, should not be changed in response to short-term and transient conditions. If a state tax policy is properly designed to grow over time with personal income to cover inflation and increased needs, if it is stable enough to not have excessive volatility, and if it is adequate to provide for the needs of a vibrant and growing society, then short-term volatility, which will inevitably be a function of a volatile economy, should be addressed in boom times by building budget reserves and cash spending on non-recurring capital projects. This will allow a state to cut expenditures during downturns in the economy and draw down budget reserves to sustain ongoing programs during economic slowdowns.

Fluctuations in state revenue are inevitable and the state's financial plan must anticipate these fluctuations. State spending to finance its commitments is much less volatile. The expense of meeting the state's largest commitment, education, does not go down as state revenue declines. In fact, the cost of postsecondary education can increase during times of economic declines because jobs are less plentiful and the need to get an education is more obvious.

Likewise, the state's second largest expenditure, Medicaid, does not decrease and, in fact, increases during economic downturns because more people become unemployed and unable to meet their own medical needs. Medicaid eligibility in Kentucky is forecasted to increase by approximately 41,000 people during FY 03, 7.2 percent above the budgeted population.

The cost of our third largest expenditure, the criminal justice system, also increases as desperate people turn to crime to sustain themselves.

And the cost of our fourth largest program, social services, goes up too.

The cost of the rest of government doesn't go down so it is almost impossible for a government to make major reductions in expenditures without adversely affecting its citizens who depend on its services.

Politicians can demagogue the issue by calling for the elimination of waste and more efficiency but when they assume the responsibility of governing, they find there is not as much waste or inefficiency as they claimed. Kentucky's EMPOWER Kentucky initiative is one of the most celebrated government

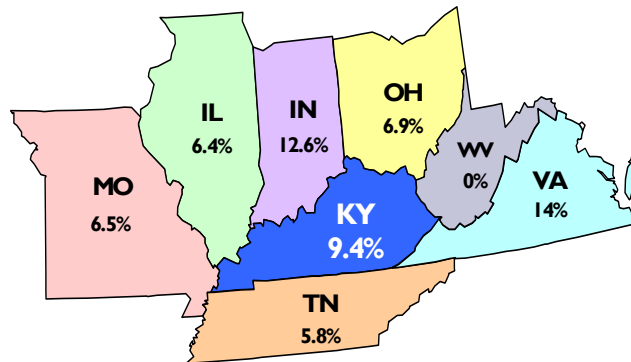
efficiency efforts in the nation. It is saving \$88.2 million in FY 03. That's still not enough to solve the problem.

### National Perspective

The revenue shortfall experienced by Kentucky in FY 02 was unprecedented, actual revenue being less than the previous year for the first time in at least fifty years. As bad as the fiscal situation is in Kentucky, other states are worse off. In FY 02, forty-six states experienced revenue shortfalls of about \$50 billion. Two of our neighboring states (Indiana and Virginia) had larger percent budget shortfalls than Kentucky.

Figure 1

### **FY 2002 Estimated Budget Shortfalls as a % of FY 2002 Budgets**



Source: NCSL Survey of National Association of Legislative Fiscal Offices, June 2002

In FY 02, states raised taxes \$3.6 billion, cut spending \$15 billion, used \$15 billion from their budget reserves, and used various other fiscal policies to accommodate the shortfall. On average, state revenue declined from the previous year by 3 percent in the last two quarters of calendar year 2001; declined 7.8 percent in the first quarter of calendar year 2002; and declined 10.4 percent in the second quarter of calendar year 2002. For all of FY 02 the average decline was about 6 percent. The decline in Kentucky was about 1.0 percent. We aren't as bad off as the average state. California is dealing with a 9.6 percent revenue shortfall, Virginia 14 percent, North Carolina 11 percent, and Iowa 11.9 percent. Sixteen states have already acknowledged that their FY 03 revenue will not reach expectations.

The national average, 11 percent increase in the cost of Medicaid last year, has exacerbated the problems. Many states are struggling to control Medicaid costs.

- Forty-five (45) states cut their Medicaid spending growth last year.
- Forty-one (41) states report that they have plans to take additional cuts this fiscal year.
- Forty (40) states are planning to implement prescription drug cost controls.
- Twenty-nine (29) states are reducing or freezing some of their provider payments.
- Fifteen (15) states are reducing Medicaid benefits.
- Eighteen (18) states are reducing or restricting Medicaid eligibility.
- Fifteen (15) states are increasing beneficiary co-payments.
- It is estimated that there will be a 6.2 percent increase in enrollment this fiscal year.

Medicaid is just one of the areas where states are cutting back on expenses. Alabama temporarily suspended jury trials. Colorado adopted early release of prisoners. Georgia cut support for colleges and universities 2 percent (as did Kentucky). Iowa cut support for county governments. Missouri failed to send out tax refunds. North Dakota cut six to seven months off sentences affecting 9 percent of inmates. Oklahoma took half the light bulbs out of state offices. Virginia cut Commonwealth University 11 percent.

Kentucky has not avoided cuts. The 5 percent overall cut in government, other than education and Medicaid, has been mostly administrative and has not yet noticeably affected service delivery.

### The Future

The Commonwealth must now face up to reality. We cannot maintain current services without more revenue. The current projected cut in FY 03 will hurt. The cuts required in FY 04 will be devastating.

It's too late for rhetoric. Kentucky has to make a hard choice. We must pay for the commitments we've made or make dramatic cuts in major government programs. No one likes to increase taxes but politicians get the blame when they have to take programs and services away from citizens once they become dependent on them just as much as they do when they raise taxes. The Department of Education is experiencing this wrath as it tries to make our programs for blind and deaf students more efficient, and they are not even trying to take money away from these programs.

It is imperative that our state revenue system be designed to produce a more consistent revenue stream insulated from economic cycles as much as possible. Temporary increases in revenue can lead to tax cuts in times of plenty. Such tax cuts are popular and can be the correct fiscal policy; however, these cuts may have to be replaced during lean times. That is what many states have already discovered as illustrated in Table 3 as reported by the National Conference of State Legislatures.

Table 3

**2002 Tax Changes in the States**

**2002 saw a total net increase in state taxes of 1.2 percent. This was the first net tax increase among the states since 1994.**

- **5 states raised taxes by more than 5 percent (IN, KS, MA, NJ, TN)**
- **11 states raised taxes between 1 and 5 percent**
- **30 states took no significant action**
- **1 state cut taxes by more than 1 percent (Hawaii)**

**Taxes were increased in most every area of taxation in the states.**

<b><u>Tax Type</u></b>	<b><u># States Increasing Taxes</u></b>	<b><u># States Decreasing Taxes</u></b>
<b>Individual Income</b>	<b>9</b>	<b>11</b>
<b>Corporation and Business</b>	<b>9</b>	<b>8</b>
<b>Sales and Use</b>	<b>6</b>	<b>9</b>
<b>Healthcare Provider</b>	<b>6</b>	<b>0</b>
<b>Cigarette</b>	<b>18</b>	<b>0</b>
<b>Alcoholic Beverage</b>	<b>2</b>	<b>0</b>
<b>Motor Fuel and Vehicle</b>	<b>5</b>	<b>0</b>
<b>Other taxes</b>	<b>4</b>	<b>0</b>
<b>Fees</b>	<b>13</b>	

Source: NCSL State Budget and Tax Actions Preliminary Report 2002

A November 14 report from the Center on Budget and Policy Priorities notes that six states raised taxes this year in excess of 3 percent of state tax revenues, and 16 states raised taxes in excess of 1 percent. Specifically, Indiana raised the sales tax, cigarette taxes, gas taxes, gambling taxes, and utility taxes. Tennessee raised the sales tax, corporate taxes, cigarette taxes, and alcohol taxes. Likewise, Kansas raised sales taxes, business taxes, gas taxes, cigarette taxes, and inheritance taxes. Also in this category of raising taxes by more than 3 percent are the states of Massachusetts, Nebraska, and New Jersey. The report points out that while many states are raising taxes, the magnitude of the tax increases will not make up the deficits that states are facing.

How Much Revenue is Enough?

Exactly how much revenue Kentucky needs could be debated endlessly. However, a good gauge is our sister states, particularly our neighboring states. There is a variety of data available about relative tax burden and one can find data to support both sides of the high tax/low tax argument. *Governing* magazine annually publishes an analysis of state (including local) tax burden. Based on this data, our total state and local tax revenue is \$2,464 per person, 11.1 percent of

personal income, (1999 data). That's 38<sup>th</sup> in the nation and third lowest among our neighboring states being only slightly higher than West Virginia (\$96) and Tennessee (\$322). The other side of this issue is that relative to our total personal income we have the 21<sup>st</sup> highest tax burden in the nation, second only to West Virginia in our region.

Evaluating available data can lead to different results as demonstrated by the fact that the Tax Foundation's analysis of 2000 data, Kentucky ranks 40<sup>th</sup> in percent of personal income devoted to state and local government.

The most reliable data may very well be two Kentucky specific reports on the tax climate in Kentucky by the Barents Group, nationally recognized financial consultants. The first study was conducted in 1995 for the Kentucky Commission on Tax Policy appointed by Governor Jones to study tax reform.

This study considered business and individual tax burdens in fifteen neighboring states in the South and Midwest. The business tax burden analysis was based on a study of sixteen industries that are important to Kentucky and considered the corporate income tax, corporate license tax, property tax, sales and use tax, and taxes on utilities.

Quoting from the study, "Kentucky's business tax structure is generally competitive for the states and industries covered by this study. Kentucky ranks tenth (or sixth lowest) of the fifteen comparison states in terms of effective tax rates on investment for the sixteen industries covered by the study. The average Kentucky effective tax rate of 9.07 percent is 9 percent below the fifteen-state average." The results for all states are in Table 4.

Table 4  
**Effective Tax Rates for Businesses in Kentucky  
and 14 Competitor States (1995 Barents Study)**

<u>Rank</u>	<u>State</u>	<u>Effective Rate</u>
1	West Virginia	13.87%
2	Louisiana	13.64%
3	Florida	11.68%
4	Ohio	11.64%
5	Tennessee	11.18%
5	Indiana	11.18%
7	Missouri	10.79%
8	South Carolina	10.13%
9	Mississippi	9.19%
<b>10</b>	<b>Kentucky</b>	<b>9.07%</b>
11	Illinois	8.96%
12	Georgia	8.58%
13	North Carolina	7.62%
14	Virginia	6.39%
15	Alabama	5.69%
	State Average	9.97%

Below are some other selected quotes from the study.

“In all four metropolitan border areas examined, Kentucky’s business taxes are lower than those in the adjacent jurisdiction across the border. Louisville’s average effective tax rate is 26.6 percent lower than that in New Albany, Indiana. Hopkinsville’s average effective tax rate is 18.0 percent below that in Clarksville, Tennessee. In Ashland, the average effective tax rate is 35.6 percent below that in Huntington, West Virginia, and in Covington, which is one of the highest tax jurisdictions in Kentucky, the average effective tax rate is 23.2 percent lower than in Cincinnati, Ohio.”

“The economic development tax credits available to certain businesses locating or expanding in Kentucky makes Kentucky’s tax system even more competitive.....”

Analyzing the effectiveness of Kentucky’s economic development tax credits, the study concluded that Kentucky had, for an eleven industry average, an average effective tax rate of 6.93 percent if the KIDA tax credit program is used, a 1.99 percent average effective tax rate if the KIRA tax program is used and a -4.31 percent average effective tax rate if the KREDA tax credit program is used. Only Alabama’s JDAF tax credit program had a lower average effective tax rate of -5.67 percent. Table 5 lists all the states’ eleven industry average effective tax rate using economic development credits.

Table 5

**Effective Tax Rates for Businesses in Kentucky and  
14 Competitor States When Economic Incentives are Utilized  
(1995 Barents Study)**

<u>Rank</u>	<u>State</u>	<u>Effective Rate</u>
1	Louisiana	12.73%
2	West Virginia	11.53%
3	Florida	11.07%
4	Ohio	10.93%
5	Indiana	10.49%
6	Missouri	9.86%
7	Tennessee	9.48%
8	South Carolina	8.76%
9	Illinois	8.64%
10	Georgia	8.01%
11	Mississippi	7.87%
12	North Carolina	6.99%
<b>13</b>	<b>Kentucky KIDA</b>	<b>6.93%</b>
14	Virginia	5.29%
15	Alabama (no JDAF)	4.24%
<b>16</b>	<b>Kentucky (KIRA)</b>	<b>1.99%</b>
<b>17</b>	<b>Kentucky (KREDA)</b>	<b>-4.31%</b>
18	Alabama (with JDAF)	-5.67%

For individuals, the study analyzed tax liabilities for five hypothetical families under the tax laws of these fifteen states. The income levels were \$20,000, \$30,000, \$50,000, \$75,000 and \$200,000. The families are two-earner married couples with two children except that the \$20,000 example assumes one child.

Quoting from the study, “the overall profile of Kentucky’s household burden is average to high in relation to the comparison states. Kentucky’s total household tax burdens are very close to the fifteen-state average at the \$20,000 family income level but are above average at higher-income levels (\$30,000 and over). Kentucky’s total household burden ranks sixth highest at the \$20,000 income level, fourth highest at the \$30,000 income level, and second highest at the \$50,000 and higher income levels.” Table 6 summarizes the rankings of the fifteen states by household incomes.

Table 6

**Kentucky and 14 Competitor States Ranked According to  
Household Tax Burden (1995 Barents Study)**

<u>State</u>	<u>\$20,000</u>	<u>\$30,000</u>	<u>Rank</u> <u>\$50,000</u>	<u>\$75,000</u>	<u>\$200,000</u>
Alabama	11	12	13	14	14
Florida	9	14	15	13	13
Georgia	8	8	7	7	7
Illinois	1	3	5	9	11
Indiana	2	2	3	5	9
<b>Kentucky</b>	<b>6</b>	<b>4</b>	<b>2</b>	<b>2</b>	<b>2</b>
Louisiana	5	13	11	11	6
Mississippi	13	15	12	12	12
Missouri	7	6	9	10	10
North Carolina	10	7	4	4	3
Ohio	3	1	1	1	1
South Carolina	15	11	6	3	4
Tennessee	12	10	14	15	15
Virginia	14	9	10	8	8
West Virginia	4	5	8	6	5

The tax structure has changed in Kentucky since the 1995 study, especially for individuals because of the many tax cuts enacted since then. The most important of the 26 different cuts in Kentucky’s tax code are: inheritance tax, \$93.1 million (all amounts are what is expected to be the size of the cut in FY 04), private pension exemption \$90.3 million, repeal of intangible tax, \$41.5 million; property tax on motor vehicles, \$70.0 million; provider tax on physicians, \$60.0 million; and sales tax on prescription drugs, \$16.2 million. Other smaller tax cuts are saving taxpayers \$113.6 million in FY 04. Other states have also changed their tax laws but no analysis of state tax cuts relative to other states has been found.

In 1999, the Patton Administration commissioned the Barents Group to update its study. This new study included the same fifteen states, except

Michigan was added and Florida was dropped. The study covered nineteen industries. Kentucky again ranked tenth from the highest (sixth from the lowest) taxed state for businesses. Table 7 summarizes the data.

Table 7

**Effective Tax Rates for Businesses in Kentucky and  
14 Competitor States When Economic Incentives are Utilized  
(1999 Barents Study)**

<u>Rank</u>	<u>State</u>	<u>Effective Rate</u>
1	Mississippi	15.34%
2	Ohio	14.44%
3	Missouri	13.73%
4	Michigan	13.11%
5	Indiana	12.97%
6	Tennessee	12.34%
7	Arkansas	11.06%
8	North Carolina	10.89%
9	Georgia	10.69%
<b>10</b>	<b>Kentucky</b>	<b>10.62%</b>
11	South Carolina	10.35%
12	Virginia	10.03%
13	Illinois	9.87%
14	West Virginia	9.50%
15	Alabama	8.68%
	Regional Average	11.57%

This study discusses the Kentucky Economic Development tax credit programs but does not do the same kind of comparison as the previous study. One would assume that the situation has not changed very much since the 1995 study.

As to individual family tax burden, the study compared sixteen states, adding Florida and Oklahoma to the list and removing Michigan. They analyzed ten different family circumstances as Table 8 illustrates.

Some selective quotes from this December 1999 report:

“Kentucky depends less on general sales taxes than do either selected comparison states or all fifty states..... Property taxes and corporate income taxes contribute a smaller percentage to total tax collections in Kentucky than in either the comparison states or the nation.”

“Kentucky’s state and local business tax system ranks tenth highest (sixth from the lowest) of the fifteen study states in terms of overall tax competitiveness across all of the study industries.”

Table 8

**Kentucky and 15 Competitor States Ranked According to  
Household Tax Burden (1999 Barents Study)**

<u>State</u>	<u>Type of Household</u>									
	<u>2 Parents 2 Children FPL</u>	<u>1 Parent 2 Children FOL</u>	<u>1 Parent 2 Children 2 x FPL</u>	<u>2 Parents 2 Children 2 x FPL</u>	<u>2 Parents 2 Children \$30,000</u>	<u>2 Parents 2 Children \$50,000</u>	<u>2 Parents 2 Children \$75,000</u>	<u>2 Parents 2 Children \$100,000</u>	<u>2 Parents 2 Children \$150,000</u>	<u>2 Parents 2 Children \$200,000</u>
Alabama	9	10	9	10	9	12	12	13	14	14
Florida	16	13	16	16	16	16	16	16	16	16
Georgia	4	4	4	5	5	5	5	6	5	5
Illinois	2	2	2	2	2	2	3	4	6	6
Indiana	1	1	1	1	1	1	1	1	1	2
<b>Kentucky</b>	<b>7</b>	<b>6</b>	<b>3</b>	<b>3</b>	<b>3</b>	<b>4</b>	<b>4</b>	<b>3</b>	<b>4</b>	<b>4</b>
Louisiana	13	8	8	11	11	13	14	14	13	13
Mississippi	15	15	13	13	13	14	13	12	12	12
Missouri	11	11	7	7	7	9	10	11	11	11
North Carolina	14	16	15	14	14	11	11	10	10	8
Ohio	3	3	5	4	4	3	2	2	2	1
Oklahoma	10	9	10	8	10	7	8	8	7	7
South Carolina	12	14	14	15	15	10	9	9	9	9
Tennessee	8	7	12	12	12	15	15	15	15	15
Virginia	5	12	11	9	8	8	7	7	8	10
West Virginia	6	5	6	6	6	6	6	5	3	3

**FPL:** Federal Poverty Level

“In general, Kentucky has lower than average business tax burdens and slightly higher than average individual tax burdens.”

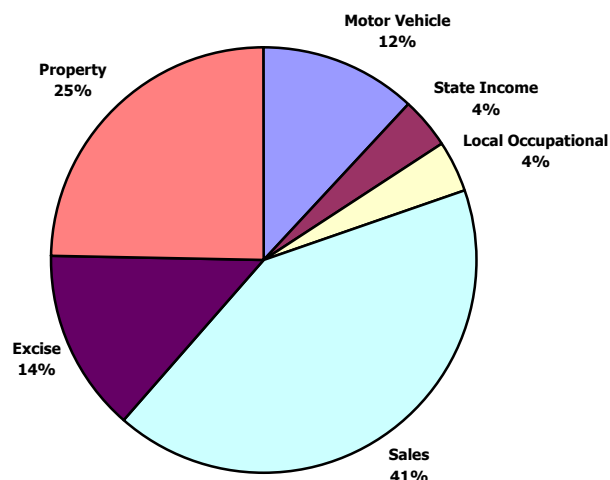
The debate about Kentucky being high tax or low tax for lower income families is particularly intense. In 2001, the LRC issued a report on this subject as well as government benefits for low-income families.

Summaries of the major conclusions of the study are provided below.

1. When comparing the tax burden as a percent of income for the lowest income families in each state, Kentucky has one of the smallest tax burdens. State and local taxes are approximately 13 percent of low-income families' income in Kentucky. Only ten states have smaller tax burdens on their low-income families than Kentucky.
2. Figure 3 shows the amounts that low-income families in Kentucky pay in each type of tax as a percent of total taxes. Kentucky's sales tax makes up the largest portion of the state and local taxes that low-income families pay. The sales tax accounted for 42 percent of the state and local taxes on low-income families in Kentucky. Kentucky's state income tax and local occupational tax are the smallest taxes that low-income families pay, each comprising 4 percent of the total.

Figure 3

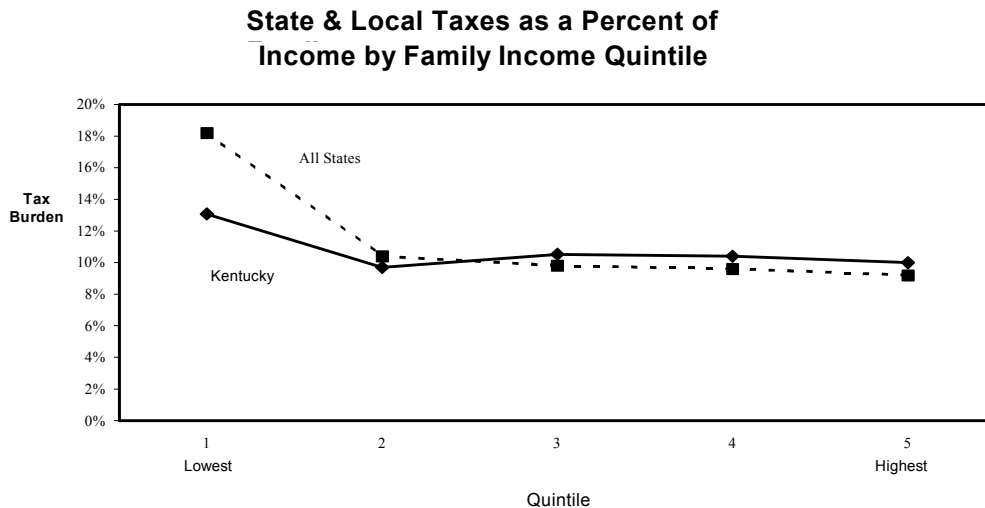
**Kentucky's State and Local Taxes  
as a Percent of Total Taxes Paid  
by Low-Income Families**



3. Figure 4 shows tax burdens as a percent of income-by-income class for Kentucky and for all states. Kentucky's taxes are generally less regressive

than the national average. There are two main reasons for this. First, Kentucky's state income tax is generally higher than the U.S. average for families in the higher-income classes. The second reason is that Kentucky has a relatively low property-tax burden for the lowest income class.

Figure 4



4. Although the tax burden as a percent of income is higher for low-income families than higher-income families, tax revenues collected from low-income families account for a relatively small share (4 percent) of the total state and local tax revenues collected from all families. Tax revenues collected from families in the highest income category accounted for 48 percent of the total tax revenues.
5. Kentucky's tax per capita for low-income families was the 10<sup>th</sup> lowest in the nation.
6. Seventy-eight percent of families defined as low-income in this study do not have children. The majority of these families are single-person families. This suggests that tax-policy options that are based only on having low income, such as Kentucky's Low-Income Tax Credit, tend to benefit single-person families with no children.
7. In 1996, Kentucky allocated 19 percent of its expenditures to programs that benefit low-income residents. Only two other states allocated a larger share. Because of Kentucky's relatively high-poverty rate, however, the state likely spreads these expenditures over a larger number of people.

In 2002, the Legislative Research Commission commissioned Dr. William Fox of the University of Tennessee to make a study of our tax structure. The report is difficult to summarize but it does quote extensively from the LRC study and the Barents report.

The most significant new information in the report by Dr. Fox is the conclusion that Kentucky has a built-in structural deficit because of the inelasticity (the inability to grow with the economy) of our revenue-generating system. This structural deficit will grow larger, forcing more and more cuts in state government as our total tax revenue becomes a smaller and smaller percent of total personal income.

This high tax/low tax burden debate could go on endlessly, but one fact cannot be disputed. Over the past twelve years, we have raised the bar in Kentucky. We have said we're going to invest in the future of our people. We are going to support education. We are going to invest in infrastructure. We are going to have a compassionate society. The question now is, are we willing to keep our commitment to our people?

Do we want to have a state which provides services (primarily education) that are comparable to our northern neighbors – Illinois, Indiana, Ohio, and Missouri (and also Virginia), or do we want to imitate West Virginia, Tennessee, Louisiana, Arkansas, Mississippi, Alabama, and Georgia? According to *Governing* magazine, the average spent on services for our people is \$2,464. The average for Illinois, Indiana, Ohio, Missouri, and Virginia is \$2,808. The average for West Virginia, Tennessee, Louisiana, Mississippi, Arkansas, and Alabama is \$2,251. We should prefer to emulate our northern neighbors. They are certainly the most prosperous.

If we want to be the lowest tax state we can do that very easily. The fact is, that the states which provide their citizens the most services (and have the highest taxes) are, in fact, the most prosperous. The state which spends most to serve its citizens is Connecticut; second is New York; third is New Jersey; fourth is Massachusetts; all very prosperous. States at the bottom are Alabama (50<sup>th</sup>), Tennessee (49<sup>th</sup>) (before it raised its sales tax rate to 9.75 percent in most areas), Mississippi (48<sup>th</sup>), West Virginia (43<sup>rd</sup>), Arkansas (42<sup>nd</sup>), and Louisiana (41<sup>st</sup>).

If we want to be a prosperous state with good services and good opportunities for our people, then we have to invest consistently in our public programs. Kentucky has not done that.

The portion of the personal income of Kentuckians devoted to state and local government declined from 11.9 percent in 1995 to 11.1 percent in 1999 (the last year for which data from *Governing* magazine is available), a decline of 6.72 percent, the largest decline of any of our neighboring states. If revenue had stayed at 11.9 percent of personal income, it would have been \$446.7 million more

in FY 99 and \$485.1 million more in FY 02, just about what it would take to solve our current problem. A \$500 million tax increase would be \$125 per person, which would move us from 38<sup>th</sup> to 32<sup>nd</sup> in per capita spending according to the *Governing* magazine data. This is an overall tax increase of about 4 percent when measured as a part of our overall state and local tax burden. The alternative is cuts of 5.2 percent in state services like education which are supported by the GF.

### Cutting the Budget

We can raise taxes or we can cut the budget. The budget shortfall for FY 03 appears to be about \$144 million and for FY 04 it's estimated to be about \$365 million. One approach, and perhaps the only politically acceptable approach, would be an across-the-board cut, exempting only debt service. This would be a "share the pain with everyone" strategy. For FY 03 this would be about 2.1 percent and for FY 04 it would be about 5.2 percent. Having already cut all of state government except education and Medicaid 5 percent in FY 02 (Medicaid and Postsecondary Education were cut 2 percent) and operating on a budget for FY 03 and FY 04 with practically no increase except the increased cost of health care for public employees and a 2.7 percent raise for state employees and school personnel, there is just simply no place to get substantial savings except to begin to cut into service delivery. An across-the-board 5.2 percent cut would affect all of the vital services provided by state government. This will require the lay-off of teachers and other school personnel, increased college tuition, the early release of prisoners, the complete elimination of some programs, and a whole array of similar cutbacks in all areas of state government. Listed in Table 9 are examples of the magnitude of such a cut.

There are four areas of the budget which are particularly stressed. These are, K-12 education, Medicaid, Corrections, and postsecondary education. Any cutback in K-12 education is a step backwards. The fact is, after the initial increase in support in FYs 91 and 92, the increase in appropriations to our common schools has averaged just 4 percent per year. In 1992, our teachers' salaries were 90.7 percent of the national average, 27<sup>th</sup> best in the nation. In 2002, our teachers' salaries had dropped to 84.9 percent of the national average, 34<sup>th</sup> best in the nation. KERA is a 24-year effort requiring continuing improvement and continually increasing investments. Any cut in K-12 funding will hurt Kentucky's progress.

Our Medicaid program, as is the case in most states, is in dire need of funds if services are not to be reduced. The budget the administration proposed (absolutely no increase in state funds above the FY 02 level in either FY 03 or FY 04 and keep in mind that the FY 02 funding had been cut 2 percent to balance the budget) had an acknowledged shortfall of \$216 million (\$65 million in state funds). 41,000 new and unbudgeted eligibles mean the shortfall will be approximately \$450 million (\$135 million in state funds). It is increasingly likely that the Patton Administration will have to consider reductions in eligibles. We have already restricted growth of provider rates as much as we can.

**TABLE 9****Impact of 5.2% Across the Board Cuts in FY 04**

	<b>FY 04 Appropriations in HB 1</b>	<b>Impact of 5.2% Budget Cut</b>
Eastern Kentucky University	\$ 76,115,100	\$ 3,957,985
Kentucky State University	\$ 23,481,500	\$ 1,221,038
Morehead State University	\$ 44,103,500	\$ 2,293,382
Murray State University	\$ 53,230,000	\$ 2,767,960
Northern Kentucky University	\$ 48,636,400	\$ 2,529,093
University of Kentucky	\$ 317,803,800	\$ 16,525,798
University of Louisville	\$ 179,095,300	\$ 9,312,956
Western Kentucky University	\$ 74,572,800	\$ 3,877,786
KCTCS	\$ 195,194,000	\$ 10,150,088
Dept. Mental Health/Mental Retardation	\$ 172,449,900	\$ 8,967,395
Department of Education*	\$ 2,948,501,200	\$ 153,322,062
Barren County	\$ 13,903,921	\$ 790,291
Boone County	\$ 25,784,524	\$ 24,478
Fayette County	\$ 60,573,419	\$ 1,010,343
Hancock County	\$ 4,285,484	\$ 271,548
Hopkins County	\$ 23,391,289	\$ 1,317,117
Jefferson County	\$ 189,485,857	\$ 11,538,262
Johnson County	\$ 15,550,126	\$ 772,610
Leslie County	\$ 8,267,879	\$ 438,004
McCracken County	\$ 17,526,480	\$ 1,151,677
Pike County	\$ 34,518,227	\$ 1,888,883
Department for the Blind	\$ 1,492,600	\$ 77,615
Medicaid	\$ 757,093,500	\$ 39,368,862
Corrections	\$ 312,307,800	\$ 16,240,006

\*Note: School District numbers are estimated per SEEK formula.

Our prison population is soaring, approximately 700 more prisoners than the Department of Corrections budgeted. The economy and increasing drug abuse are the primary drivers. All economy measures the department can make have failed to cover the shortfall. The only tool left is to reduce the sentence of our least dangerous inmates. Several states have already resorted to this measure. This will impact county governments because that's where the cuts will be made. Every \$10,000 cut will mean one more inmate released since this reduction in inmate population will come from the population the state is housing in county jails; this will mean \$10,000 less revenue for a county for every inmate taken out of their jail.

Our colleges and universities have done what we asked them to do; provide more high quality education to Kentucky citizens. Enrollment is up 14.4 percent since the 2000-2001 school year but our support for these institutions has only increased 6 percent. If state government doesn't provide the funds it takes to provide the education our people have to have, then the students will have to pay the difference through increased tuition. If our universities have to limit enrollment due to budget cuts, every \$11,220 cut probably means that one Kentuckian won't get a postsecondary education.

When these decisions get specific, they get more difficult.

The biggest controversy in the 2002 budget debate was funding school personnel raises. The biggest controversy in the 2000 session was funding the increases needed for our colleges and universities to do what we asked them to do. Because these areas have already absorbed a substantial budget reduction, they should be exempted from any more budget cuts; however, every area exempted makes the burden on the rest of government greater.

If K-12 education, which is 42 percent of the GF budget, is spared, the across-the-board cut to the rest of government will almost double to 9.1 percent. If K-12 education and prisons are spared the cut, the rest of government will be cut 9.9 percent. If K-12, prisons, and Medicaid are spared the cut, the rest of government will be cut 12.4 percent. If K-12, prisons, Medicaid, and postsecondary education are spared, the rest of government will be cut 20.5 percent. There are no good choices.

### Conclusion

The pain can no longer be delayed. We must decide.

We must debate both sides of this issue. The Governor invites the leadership of both houses of the legislature to sit down with officials of our administration and explore both options in detail. Let's decide where we would make the cuts, if indeed our decision is to cut the state budget to solve the

problem. Let's have an honest discussion about where more revenue could be raised if our decision is to keep our commitments by raising revenue. Is expanding gaming a solution? Not in the short run because it could not be brought online fast enough to be of any significant help during the current biennium. Should the corporate support of state government be restored to its 1990 level? What effect would that have on our economy? These are all questions that need to be debated.

The administration has invited every current candidate for governor to be briefed on the budget so they can discuss the subject having a knowledge of the facts.

This is a process we should begin now. The administration desires to recommend a budget to the General Assembly in February of next year that will have the support of the leadership of both chambers.

Regardless of the choice of how we resolve this current dilemma, cuts or more revenue, the time has come for comprehensive tax reform, be it revenue neutral or a vehicle to solve our problem.

If we had done this a year ago or three years ago, our problem would not be as bad as it is today. If we don't do it now, our problem will continue to reoccur and get worse because our tax code generates revenue too erratically; producing excess revenue in boom times and these kinds of revenue shortages when we need it the most, times of economic hardship. We need to address the fact that state revenue is not growing as much as our economy grows over time.

It goes without saying that comprehensive tax reform will have to be bipartisan. The Republican Party controls the state Senate. The Democratic Party controls the House. Our choice is compromise or stalemate. We must have compromise. Governor Patton can and will be an honest broker. Real progress can only be made when the Governor is involved and in good faith helps focus the people on the real issues. He is prepared and expects to do that. The administration has no other agenda until we get a budget.